



State Tax Treatment of Investment Partnerships

Multistate Tax Commission

2022

This white paper is a draft prepared by the staff of the Multistate Tax Commission (MTC) as part of its uniformity project on state taxation of partnerships and is subject to revision.

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EXECUTIVE SUMMARY

This white paper was prepared by the staff of the Multistate Tax Commission with the advice and assistance of a work group of member states established by the MTC uniformity committee. The work group was created to study how states might tax multistate income arising from partnerships in a more compatible and uniform manner—consistent with established state tax policies and the shared principles for dividing multistate income.

The workgroup initially developed a comprehensive outline of issues in the partnership tax area that the states might need to address. The development of that outline showed that specific rules for particular facts and circumstances were often lacking. But one area where there seemed to be specific rules in many states, and some consistency between those rules, was the treatment of partnerships engaged primarily in investment activity. The workgroup decided to address the question of the taxation of investment partnership income initially through a white paper which would evaluate this treatment.

In order to evaluate the treatment, this white paper first considers the state tax system for taxing partnership income generally. That system includes conformity to the federal substantive tax rules, which often specify special treatment for investment income, as well as the pass through tax system created under the Internal Revenue Code Subchapter K, which most states use for taxing partnerships, including investment partnerships. The white paper also considers the general state sourcing rules for sourcing the income of multistate partnerships as well as important enforcement mechanisms. The states that specify particular treatment of investment partnership income typically vary the general sourcing and reporting requirements for this income, but investment partnerships may still be subject to these general requirements depending on the states in which they operate and the nature of their investments.

The white paper then summarizes information and data to better describe the broad category of investment partnerships. Investment partnerships are often thought of as primarily including private equity and hedge funds, which are lightly regulated and typically formed as partnerships rather than regulated investment companies. But a comparison of the data from IRS and other sources appears to indicate that assets and income reported by partnerships that designate themselves as being in the investment sector may be twice as great as the assets and income reported in industry data tracking private equity and hedge funds. So a significant portion of income self-reported as investment income maybe from partnerships other than typical private equity hedge funds, which may include closely-held partnerships and special purpose entities.

Next the white paper surveys the existing state rules for the treatment of investment partnership income that have been adopted in about half the states. These rules source investment partnership income to the partner's state of residence. While this treatment is consistent, many other things about these rules may vary from state to state, including the definition of an investment partnership and exactly how the sourcing rule applies to various types of income and partners. A few states appear to have much more well-developed rules. It also appears the basis for, and policy behind, these rules may vary from state to state, which may affect their application.

Finally, this white paper evaluates the treatment of investment partnership income generally, and specific differences in that treatment from state to state. **[PENDING]**

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INTRODUCTION

When you imagine a partnership, you may picture a small local business or a professional firm. Such partnerships are numerous, but as a group, the income they generate is only a small fraction of the total income generated by all partnerships. The majority of partnership income is generated by entities whose primary activity, broadly speaking, is investment.

The system states use to tax the income of partnerships, including investment partnerships, generally conforms to both the federal substantive tax rules and to the federal passthrough system—taxing income to the partners. A number of federal tax rules distinguish certain types of investment income for particular treatment.

But the state system must also determine the source of multistate income. In general, states determine the source of partnership income based on the operations of the partnership. But many states source the income from certain qualifying investment partnerships to the partner's residence, instead. This special state-sourcing treatment may take different forms—a specific exemption or exclusion for nonresidents, a special sourcing rule, or a determination that the nonresident partners are not “engaging in business” in the state.

While the form of this special sourcing treatment is important, deciding which types of partnerships to include in this special treatment is critical to achieving equity—both between ordinary and investment partnerships, and between investors who hold investments directly and those who hold investments through a partnership.

Moreover, state rules vary. Some states have no special rule for sourcing investment partnership income. Those that do, may apply the rules to a broader, or narrower, category of partnerships. And investment partnerships themselves differ—ranging from smaller, closely-held partnerships to those that are similar to regulated mutual funds—and everything in between. Also, a substantial amount of the income of these investment partnerships comes from holdings in “portfolio companies” which may be other partnerships, whose income, in turn, may be subject to different state sourcing rules where they operate.

In addition, it would be difficult, if not impossible, to overstate the complexity presented by investment partnerships which often involve dozens or hundreds of separate special-purpose entities and complicated profit-sharing agreements between partners, as well as complex financial deals involving years-long investment strategies and related transactions. At the federal level, this complexity has generally defied the ability of the Internal Revenue Service to ensure compliance through audits. At the state level, rules are often not well developed, nor does the simple absence of specific rules necessarily indicate that the general rules are otherwise applicable, or if so, how they apply.

To evaluate the special sourcing rules used by states for investment partnership income, this white paper begins with an overview of the state partnership tax system—including federal conformity, state sourcing generally, and enforcement mechanisms. It then, describes the different types of partnerships that may engage in investment activities—their structure, management, and operations. Next, it surveys the state sourcing rules some states have adopted for investment partnership income, noting the differences. Then, finally, it evaluates this special sourcing treatment, the policies it may embody, and the implications of state variations.

Note: Unless otherwise indicated by the context—the term “investment partnership,” as used throughout this paper, connotes a partnership whose activities primarily involve investing generally, whether or not those partnerships would qualify as “investment partnerships” for particular state tax treatment.



SECTION I: THE STATE PARTNERSHIP TAX SYSTEM

Information in this section comes from multiple sources. In addition to sources cited, see the MTC's project page on state taxation of partnerships, here: <https://www.mtc.gov/Uniformity/Project-Teams/Partnership-Tax>

Purpose of this Section I

Section I provides an overview of the three main components of the state system for taxing partnership income, generally, noting differences in the treatment of investment partnerships, and the implications:

- A. Federal Conformity - substantive tax rules, including rules for investment income and entities, and the passthrough system
- B. State Sourcing Rules - methods for sourcing multistate income from partnerships
- C. Necessary Enforcement Mechanisms - mechanisms essential to making the system work
- D. General Implications for Investment Partnerships

I. A. Federal Conformity – Substantive Tax Rules and the Passthrough System

States generally conform to both the federal substantive tax rules found in the Internal Revenue Code (IRC) and to the federal passthrough system, found in IRC Subchapter K, used to tax partnerships.¹ This Section I. A. describes how the substantive rules and the passthrough system work together. Also, it briefly summarizes particular federal rules applying to certain investment partnerships.

Substantive Tax Rules - Generally

States generally conform to federal substantive rules for the tax treatment of various items of income, expense, gain, and loss from business and investment activities. Items may be exempt or taxable, deductible or amortizable, ordinary or capital, currently recognizable or deferred, etc.² Examples of the substantive rules include the rules for determining:

- Gross Income - Including compensation, business income, gains, interest, rents, and the “distributive share of partnership gross income,” etc.). See IRC § 61 as well as §§71-91.
- Exempt or Excluded Income - See IRC §§ 104-140.
- Itemized Deductions - Including ordinary and necessary business expenses (IRC § 162), taxes (IRC § 164), depreciation (IRC § 167), net operating loss deductions (IRC § 172), and others.
- Nondeductible Expenses - Including expenses that must be capitalized and depreciated or amortized. See IRC §§ 261-280H.
- Inventory Expenses - See IRC § 471-475.
- Capital Assets and Gains and Losses - See IRC §§ 1001-1298.

Passthrough Tax System - Generally

Subchapter K creates the system for passing through the partnership's items of income, expense, gain, and loss to the partners. Among other things, the rules provide:

- Items retain their character as they pass through. See IRC § 702.
- Partnerships have flexibility in allocating distributive shares of partnership items to the partners, provided those allocations have substantial economic effect. See IRC § 704.
- How transactions with partners and guaranteed payments are treated. See IRC § 707.
- General non-recognition treatment of contributions to the partnership. See IRC §§ 721-724.
- General non-recognition treatment of distributions from the partnership. See IRC 731-737.
- Treatment of transfers of partnership interests. See IRC §§ 741-743.

¹ Exceptions are the District of Columbia, New Hampshire, Connecticut, and Texas, which impose entity-level taxes. But Texas also excludes “passive” entities that primarily engage in investment activities. See Tex. Tax Code §§ 171.0002-4.

² States may make adjustments to certain federal items, e.g. depreciation expense or NOL deductions.

Federal Reporting System

Under the pass-through system created by Subchapter K, the partnership is responsible for reporting the items of income, expense, gain, and loss (“partnership items”)³ from its activities, applying the federal substantive tax rules to those items. (See the Form 1065 partnership return, below.) But the partnership does not pay tax on the net income that may result from these tax items.

Form 1065		U.S. Return of Partnership Income		OMB No. 1545-0123
Department of the Treasury Internal Revenue Service		For calendar year 2020, or tax year beginning _____, 2020, ending _____, 20		2020
		Go to www.irs.gov/Form1065 for instructions and the latest information.		
A Principal business activity	Name of partnership			D Employer identification number
B Principal product or service	Type or Print	Number, street, and room or suite no. If a P.O. box, see instructions.		
C Business code number	City or town, state or province, country, and ZIP or foreign postal code			E Date business started
				F Total assets (see instructions)
				\$
G Check applicable boxes: (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change (5) <input type="checkbox"/> Amended return				
H Check accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ▶				
I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶				
J Check if Schedules C and M-3 are attached ▶ <input type="checkbox"/>				
K Check if partnership: (1) <input type="checkbox"/> Aggregated activities for section 465 at-risk purposes (2) <input type="checkbox"/> Grouped activities for section 469 passive activity purposes				
Caution: Include only trade or business income and expenses on lines 1a through 22 below. See instructions for more information.				
Income	1a Gross receipts or sales	1a		
	b Returns and allowances	1b		
	c Balance. Subtract line 1b from line 1a			1c
	2 Cost of goods sold (attach Form 1125-A)			2
	3 Gross profit. Subtract line 2 from line 1c			3
	4 Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)			4
	5 Net farm profit (loss) (attach Schedule F (Form 1040))			5
	6 Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)			6
7 Other income (loss) (attach statement)			7	
8 Total income (loss). Combine lines 3 through 7			8	
Deductions (see instructions for limitations)	9 Salaries and wages (other than to partners) (less employment credits)			9
	10 Guaranteed payments to partners			10
	11 Repairs and maintenance			11
	12 Bad debts			12
	13 Rent			13
	14 Taxes and licenses			14
	15 Interest (see instructions)			15
	16a Depreciation (if required, attach Form 4562)	16a		
	b Less depreciation reported on Form 1125-A and elsewhere on return	16b		16c
	17 Depletion (Do not deduct oil and gas depletion.)			17
18 Retirement plans, etc.			18	
19 Employee benefit programs			19	
20 Other deductions (attach statement)			20	
21 Total deductions. Add the amounts shown in the far right column for lines 9 through 20			21	
22 Ordinary business income (loss). Subtract line 21 from line 8			22	
Tax and Payment	23 Interest due under the look-back method—completed long-term contracts (attach Form 8697)			23
	24 Interest due under the look-back method— income forecast method (attach Form 8866)			24
	25 BBA AAR imputed underpayment (see instructions)			25
	26 Other taxes (see instructions)			26
	27 Total balance due. Add lines 23 through 26			27
	28 Payment (see instructions)			28
	29 Amount owed. If line 28 is smaller than line 27, enter amount owed			29
	30 Overpayment. If line 28 is larger than line 27, enter overpayment			30
Sign Here	Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than partner or limited liability company member) is based on all information of which preparer has any knowledge.			
	Signature of partner or limited liability company member		Date	
	May the IRS discuss this return with the preparer shown below? (See instructions.) <input type="checkbox"/> Yes <input type="checkbox"/> No			
Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed PTIN
	Firm's name ▶	Firm's EIN ▶		
	Firm's address ▶	Phone no.		
For Paperwork Reduction Act Notice, see separate instructions.		Cat. No. 113907		Form 1065 (2020)

³ A “tax item” or “item” is any element or group of elements that has a particular effect on the tax calculation—that is, whose character (e.g. ordinary versus capital, deductible versus depreciable, etc.) determines how it is treated for tax purposes. This paper often uses the term “partnership items” or “partnership tax items” rather than “partnership income” to describe what partnerships report and allocate to their partners. Not only is this technically correct, but it affects how partners are taxed, as discussed further below. See IRC § 702.

Instead, after determining the proper tax treatment of the items resulting from its activities, the partnership “allocates” a “distributive share” of those items to each partner, according to the partnership agreement.⁴ The taxpaying partners must then include their share of the items in their own tax returns and use them in their calculation of the total taxable income on which tax is due.⁵ Partnerships must therefore provide their partners with detailed information so they can properly report their shares of the partnership items. (See the federal Schedule K-1, below.)

651121
OMB No. 1545-0123

2021

Schedule K-1
(Form 1065)
Department of the Treasury
Internal Revenue Service

For calendar year 2021, or tax year
beginning / / 2021 ending / /

Partner's Share of Income, Deductions, Credits, etc.
▶ See back of form and separate instructions.

Part I Information About the Partnership		Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items																	
A Partnership's employer identification number	1 Ordinary business income (loss)	14 Self-employment earnings (loss)																	
B Partnership's name, address, city, state, and ZIP code	2 Net rental real estate income (loss)	15 Credits																	
C IRS center where partnership filed return ▶	3 Other net rental income (loss)	16 Schedule K-3 is attached if checked ▶ <input type="checkbox"/>																	
D <input type="checkbox"/> Check if this is a publicly traded partnership (PTP)	4a Guaranteed payments for services	17 Alternative minimum tax (AMT) items																	
E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)	4b Guaranteed payments for capital	18 Tax-exempt income and nondeductible expenses																	
F Name, address, city, state, and ZIP code for partner entered in E. See instructions.	4c Total guaranteed payments	19 Distributions																	
G <input type="checkbox"/> General partner or LLC member-manager <input type="checkbox"/> Limited partner or other LLC member	5 Interest income	20 Other information																	
H1 <input type="checkbox"/> Domestic partner <input type="checkbox"/> Foreign partner	6a Ordinary dividends	21 Foreign taxes paid or accrued																	
H2 <input type="checkbox"/> If the partner is a disregarded entity (DE), enter the partner's: TIN _____ Name _____	6b Qualified dividends	22 <input type="checkbox"/> More than one activity for at-risk purposes*																	
I1 What type of entity is this partner? _____	6c Dividend equivalents	23 <input type="checkbox"/> More than one activity for passive activity purposes*																	
I2 If this partner is a retirement plan (IRA/SFP/Koogh/etc.), check here ▶ <input type="checkbox"/>	7 Royalties	*See attached statement for additional information.																	
J Partner's share of profit, loss, and capital (see instructions): <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th colspan="2" style="text-align: center;">Beginning</th> <th colspan="2" style="text-align: center;">Ending</th> </tr> </thead> <tbody> <tr> <td style="width: 25%;">Profit</td> <td style="width: 25%;">%</td> <td style="width: 25%;">%</td> <td style="width: 25%;">%</td> </tr> <tr> <td>Loss</td> <td>%</td> <td>%</td> <td>%</td> </tr> <tr> <td>Capital</td> <td>%</td> <td>%</td> <td>%</td> </tr> </tbody> </table>	Beginning		Ending		Profit	%	%	%	Loss	%	%	%	Capital	%	%	%	8 Not short-term capital gain (loss)	9a Net long-term capital gain (loss)	10 Net section 1231 gain (loss)
Beginning		Ending																	
Profit	%	%	%																
Loss	%	%	%																
Capital	%	%	%																
K Partner's share of liabilities: <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th colspan="2" style="text-align: center;">Beginning</th> <th colspan="2" style="text-align: center;">Ending</th> </tr> </thead> <tbody> <tr> <td style="width: 25%;">Nonrecourse</td> <td style="width: 25%;">\$</td> <td style="width: 25%;">\$</td> <td style="width: 25%;">\$</td> </tr> <tr> <td>Qualified nonrecourse financing</td> <td>\$</td> <td>\$</td> <td>\$</td> </tr> <tr> <td>Recourse</td> <td>\$</td> <td>\$</td> <td>\$</td> </tr> </tbody> </table>	Beginning		Ending		Nonrecourse	\$	\$	\$	Qualified nonrecourse financing	\$	\$	\$	Recourse	\$	\$	\$	9b Collectibles (28%) gain (loss)	9c Unrecaptured section 1250 gain	11 Other income (loss)
Beginning		Ending																	
Nonrecourse	\$	\$	\$																
Qualified nonrecourse financing	\$	\$	\$																
Recourse	\$	\$	\$																
L Partner's Capital Account Analysis <table style="width: 100%; border-collapse: collapse;"> <tbody> <tr> <td style="width: 50%;">Beginning capital account</td> <td style="width: 50%;">\$</td> </tr> <tr> <td>Capital contributed during the year</td> <td>\$</td> </tr> <tr> <td>Current year net income (loss)</td> <td>\$</td> </tr> <tr> <td>Other increase (decrease) (attach explanation)</td> <td>\$</td> </tr> <tr> <td>Withdrawals and distributions</td> <td>\$ ()</td> </tr> <tr> <td>Ending capital account</td> <td>\$</td> </tr> </tbody> </table>	Beginning capital account	\$	Capital contributed during the year	\$	Current year net income (loss)	\$	Other increase (decrease) (attach explanation)	\$	Withdrawals and distributions	\$ ()	Ending capital account	\$	12 Section 179 deduction	13 Other deductions	12 Section 179 deduction				
Beginning capital account	\$																		
Capital contributed during the year	\$																		
Current year net income (loss)	\$																		
Other increase (decrease) (attach explanation)	\$																		
Withdrawals and distributions	\$ ()																		
Ending capital account	\$																		
M Did the partner contribute property with a built-in gain (loss)? <input type="checkbox"/> Yes <input type="checkbox"/> No If "Yes," attach statement. See instructions.	13 Other deductions	22 <input type="checkbox"/> More than one activity for at-risk purposes*	23 <input type="checkbox"/> More than one activity for passive activity purposes*																
N Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss) <table style="width: 100%; border-collapse: collapse;"> <tbody> <tr> <td style="width: 50%;">Beginning</td> <td style="width: 50%;">\$</td> </tr> <tr> <td>Ending</td> <td>\$</td> </tr> </tbody> </table>	Beginning	\$	Ending	\$	22 <input type="checkbox"/> More than one activity for at-risk purposes*	23 <input type="checkbox"/> More than one activity for passive activity purposes*	21 Foreign taxes paid or accrued												
Beginning	\$																		
Ending	\$																		

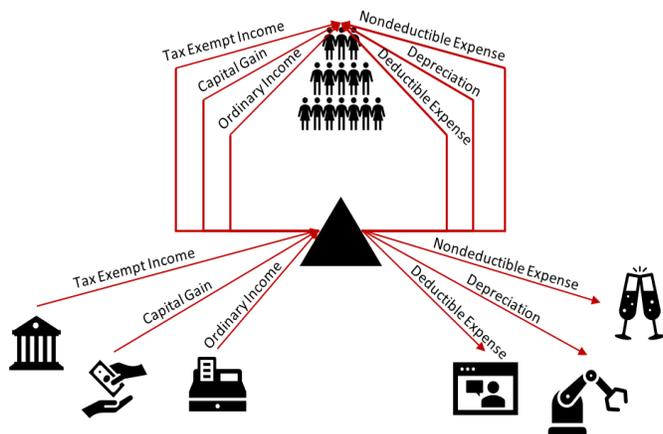
For Paperwork Reduction Act Notice, see the Instructions for Form 1065. www.irs.gov/Form1065 C&L No. 11394R Schedule K-1 (Form 1065) 2021

⁴ As will be discussed further, this represents an important policy underlying the federal passthrough system—that the tax treatment should conform to the economic agreement between the partners, so long as the agreement has real economic substance and business purpose—referred to generally as substantial economic effect. See IRC § 704.

⁵ The terms “distributive share” and “allocate” as used in this white paper have the same meaning as in IRC § 704. Distributive share refers to the portion of partnership items allocated to the partners each year. Distributive share is not the same as a “distribution.” Partners will have distributive share of partnership items each year, whether or not they receive any actual distribution from the partnership. “Allocate” is used to describe the assignment of distributive share to the partners. See IRC § 704(b)(2). While “allocate” is often used in the state tax sourcing context as well, we will refrain from that use to avoid confusion.

Partnership Items Retain Their Substantive Character

There is a critical relationship between the federal substantive tax rules and the federal passthrough system. Once the character of partnership items is determined by application of the substantive tax rules at the partnership level, that character does not change as the items pass through to the taxpaying partners. This reflects a fundamental policy explicitly embodied in the federal system—that the partners’ tax result should be the same as if they earned or incurred the partnership items directly. See IRC § 702. While the graphic below depicts the flow-through of items and their character in simple terms (where there is a single partnership), it also applies where there are multiple partnership tiers.



Moreover, unless the partner provides specific notice to the IRS, the treatment of partnership items on a partner's return must be consistent with the treatment of such items on the partnership return in all respects, including the amount, timing, and characterization of such items. Nor can partnerships take one position on the 1065 Return and a separate position on the items when reporting them to the partners on the Schedule K-1s. If a partner fails to satisfy the notice requirements for taking an inconsistent position, the IRS may summarily adjust the item and assess any tax. See IRC § 6222.

Types of Partners and Partner Attributes

Unlike S corporations, there are no federal tax limits on the number or type of persons who may be partners in the typical partnership.

- Taxpaying (or Exempt) Partners – Partners may be taxpaying persons—individuals, corporations, or taxable trusts. Or they may be tax-exempt entities, including pension funds and governments. And partners may be domestic or foreign individuals or entities.
- Tiered Partners – Partners may also be other partnerships.⁶ In that case, the “lower-tier” partnership’s items of income, expense, gain, and loss flow through any “upper-tier” partnerships until they are allocated to taxpaying or tax-exempt persons (sometimes referred to as “indirect” partners). Tiered partnership structures are common among investment partnerships.

The federal tax treatment of different partners—e.g. individuals, corporations, tax-exempt entities, foreign persons—will ultimately determine how partnership items are reported and taxed.

Effect of State Entity-Level Taxes on the System and Tax Due

While states generally conform to the passthrough system, they have adopted different forms of entity-level taxes for enforcement purposes (i.e. withholding), taxpayer convenience (i.e. composite return elections), and to allow their residents to avoid the TCJA’s federal cap on the state and local tax deduction (so-called “PTE taxes”). These entity-level impositions vary.⁷ The effect of entity-level taxes on sourcing is discussed in Section I.B and their use for enforcement purposes is discussed in Section I.C below. Note, that even though investment partnerships subject to special sourcing treatment may also be excluded from some entity-level taxes, they may hold interests in portfolio companies which may not be excluded.

⁶ Partners may also be Subchapter S corporations or non-taxable trusts. This paper does not specifically address these other passthrough partners in any detail, but the basic sourcing issues presented by such partners are similar to those presented by partnership partners.

⁷ See, for example, Steven N.J. Wlodychak, “They’re All Different and That’s the Problem: State PTEs,” Tax Notes State, Vol. 101, p. 455, Aug. 2, 2021, available here: [https://www.mtc.gov/MTC/media/Partnership/Wlodychak-Article-on-PTE-Taxes-\(08-02-2021\).pdf](https://www.mtc.gov/MTC/media/Partnership/Wlodychak-Article-on-PTE-Taxes-(08-02-2021).pdf).

Entity-level taxes are often imposed only on the distributive share of partnership items allocated to certain partners. But entity-level taxes, even when imposed on total partnership income, can never match exactly the combined taxes owed by the partners on a passthrough basis—and in this sense—these entity-level taxes are disruptive to the functioning of that passthrough system as described above.

What determines the tax under the traditional passthrough system is the combination of the character of partnership items with the partners' own tax attributes. For example, a partner that has capital losses from other sources may receive a tax benefit from an allocation of the partnership's capital gains in a way that a partner with ordinary losses would not. Also, federal tax rates applicable to individual partners vary substantially based on total income, and the rates between individual and corporate partners also vary. At the federal level progressive rates range from 10-37% for individuals whereas corporate taxes are a flat 21%. At the state level, while states also have progressive rates, the range is much lower, usually less than 5 percentage points, and the difference between the effective rates for individuals and corporations also varies much less.

Specific Federal Provisions Relating to Investment Partnerships

Some federal substantive rules, as well as particular rules under Subchapter K, single out certain types of investment income or investment partnerships for particular treatment. While these rules do not dictate any particular state sourcing rules, they may affect the ultimate calculation of the state tax base for investment partnerships. So, while a detailed discussion of these particular federal rules is beyond the scope of this white paper, the summary below may assist in evaluating the state sourcing of investment income. The provisions covered here include:

- Beneficial federal treatment of capital gains and investment income
- Loss limitation rules and their effect on income from investment partnerships
- Exceptions to the non-recognition rules for partnership contributions and distributions
- Flexible income sharing arrangements and treatment of carried interest
- Investment income versus unrelated business income and effect on tax-exempt organizations
- Effectively connected income and effect on foreign partners
- Publicly traded partnerships
- Non-partnership investment entities

Note that there is no single federal definition of “investment income” or an “investment partnership.” Different federal tax provisions are pinned to slightly different definitions or distinctions between investment and non-investment activities. Therefore, when considering the different treatment of an “investment partnership” under federal law, it is important to reference the specific definition used for that purpose.

Beneficial Federal Treatment of Capital Gains and Investment Income

Certain investment income, including capital gains from the sale of portfolio companies, maybe subject to beneficial federal tax treatment. This treatment typically includes either lower tax rates or exclusions or deferrals from tax. Examples include the following:

- The capital gains rate for individuals, which applies to capital gains and to other investment income, is lower than the rate imposed on ordinary income—often less than half the ordinary income tax rate. See IRC § 1(h).
- Certain gains from the sale of stock in certain small businesses may be partially or entirely excluded from tax if the stock was acquired after a particular date and held for a minimum period of years. This exclusion will also apply to persons who have gains from qualifying stock held through a partnership. See IRC § 1202.

- Gains arising in a so-called “like-kind” exchanges may be deferred, with few limits, if the proceeds from the sale is re-invested in similar property. If the property is held by a partnership, the entity must elect the deferral which will then apply to all the partners. See IRC § 1031.
- The Tax Cuts and Jobs Act (TCJA) provided a tax benefit for those investing gains from appreciated assets into so-called “opportunity zones,” designated by states. The gains are then deferred until the end of 2026. Investors may also get a basis step-up in their investment in the opportunity zone, or in the case of investments made for longer than 10 years, may be able to exclude any gains.⁸

This federal treatment of investment income can affect state taxation of the same income in various ways. Even beneficial federal tax rates, which were not binding on states, may tend to influence how partnerships are structured and how income is generated so as to obtain that beneficial federal treatment. This incentive to seek investment income status, as opposed to ordinary income status, may have effects on state taxes. Another example is the sourcing of deferred gains from like-kind exchanges. States have sometimes grappled with how to source the deferred gains where the sale of property occurs in one state and the reinvestment in other property occurs in a separate state.

Loss Limitation Rules – Effect on Income from Investment Partnerships

Partners may have deductions or losses from one partnership and income or gains from another. A number of important limitations may apply to offsetting these items.

- Capital Gains & Losses – Under IRC § 1211, partners cannot simply deduct capital losses against any income, but may use capital losses to offset capital gains, with any unused capital losses carried forward. (Individuals can generally deduct an additional \$3,000 against other income.)
- Outside Basis – In addition to the limitation on the use of capital losses, partners can only claim deductions for the expense/loss of ongoing partnerships to the extent of their “outside basis,” that is, their tax basis in their partnership interest. IRC § 705(a)(2). When a partnership is liquidated, or the partner sells the partnership interest, suspended losses may be deducted in full—to the extent of other federal limitations. IRC §§ 731 and 741.
- At-Risk Loss Limits – The ability to offset losses may also be limited by the at-risk loss rules of IRC § 465.⁹
- Passive-Loss Limits – Losses will also be limited if they are “passive” under IRC § 469.¹⁰ These limits apply to partners taxed as individuals and closely-held C corporations. (See also the discussion of tax-exempt organizations below).

Most investment income takes the form of capital gain or loss—including sales of securities and sales of interests in partnerships. See IRC § 741. Therefore, the capital loss limitations will apply. However, the passive-loss limits will generally not apply to investment income—sometimes called “portfolio income.” See IRC § 469(e)(1)(A) and § 469(e)(3). Gains or losses from the sale of an interest in another partnership may also be considered portfolio (non-passive) items not subject to loss limitations.

⁸ See the IRS webpage on opportunity zone investments, here: <https://www.irs.gov/credits-deductions/businesses/opportunity-zones>.

⁹ The at-risk rules of IRC § 465 apply broadly to activities that generate income and loss, including to partnerships. The first step in applying the at-risk rules is to determine what activities are considered related for purpose of computing the loss that might be subject to the at-risk limit. There is no limit in offsetting losses and deductions against the income or gains of that related activity. Any resulting loss, however, is limited in terms of being deducted against income from other activities to the extent of the partner’s at-risk investment, as determined under the applicable rules.

¹⁰ Passive-loss rules of IRC § 469 provide that losses from passive activities cannot be used to offset income from other unrelated activities. Similar to the at-risk rules, the first step is to determine which activities are both passive and related in terms of calculating any loss that may, then, be subject to the passive loss rules—limiting its offset against unrelated income. A passive activity is a trade or business in which the taxpayer (partner) does not materially participate. The partnership income of limited partners is typically treated as passive income or loss, with some exceptions.

States that conform to the federal substantive rules may also allow these items of income and loss to be offset, subject to the same general limits—but they would do so only to the extent that the offsetting income or loss are properly sourced to the state. The effects of sourcing income, gains, and losses for state purposes are discussed further in Section I.B. below.

Exceptions to the Non-Recognition Treatment of Contributions and Distributions

Under IRC § 721, contributions to a partnership are generally given non-recognition treatment, meaning that even when property with a built-in gain or loss is contributed in exchange for a partnership interest, there will be no gain or loss recognized by the partner or the partnership. But this non-recognition treatment does not apply to gains that would otherwise be realized on a transfer of property to a partnership which would be treated as an investment company under IRC § 351 if the partnership were incorporated. See IRC § 721(b). Note that the exception applies only to gains and not to losses.¹¹

Under IRC § 731, partnership distributions are generally given non-recognition treatment, with certain exceptions—the broadest of which is when the partner receives money in excess of the partner’s outside basis (the tax basis in the partner’s partnership interest). “Money,” for this purpose, includes the fair market value of marketable securities. But there is an exception to the requirement to recognize gain where the distribution is marketable securities made by an investment partnership to an eligible partner.¹²

Flexible Income Sharing Arrangements and Treatment of Carried Interest

Subchapter K allows significant flexibility to partners in sharing partnership items, regardless of their share of the partnership capital. See IRC § 704(b). Nor do the reasons for such “special allocations” change the character of those items. There is a separate, but related, concept employed by investment partnerships. Such partnerships are typically managed by a managing partner or member (“manager”), often a firm that regularly engages in such activities. The manager may make a small capital contribution to the partnership. But the manager will also generally be granted a “carried interest” in the partnership, which is a type of profits interest that represents a right to a distributive share of the partnership’s profits, rather than to any of the partnership’s capital. Granting this profits interest is a non-recognition event—so the manager will not recognize income for the services that the manager provides. See Rev. Proc. 93-27.

The manager will also typically hire other firms to provide particular services for the investment partnership. Typically, the service firms will also receive a profits interest either separately or as part of an arrangement (generally a tiered partnership) with the manager. These carried interest or profits interests entitle the manager and other service partners to distributive share income of the investment partnership—which will consist almost entirely of items subject to beneficial capital gains treatment. The TCJA required managers who received a profits interest to hold that interest for three years in order to receive capital gains treatment.¹³ See IRC § 1061.

Investment Income versus Unrelated Business Income and Effect on Tax-Exempt Organizations

As will be discussed further in Section II, investment partnerships often have tax-exempt entities as partners (e.g. pension funds or foundations). When such entities receive unrelated business income from partnerships in which they are invested, they will owe tax. IRC § 512. Certain types of investment income, however, including gains and losses from the disposal of property not used in a business, is exempt from unrelated business income tax (UBIT). IRC § 512(b).

¹¹ This exception is designed to prevent use of a partnership to engage in tax-free diversification of a taxpayer’s investments in certain cases, and is similar to an exception provided for transfers to corporations in exchange for stock. Regulations provide that a partnership is an investment company if immediately after the receipt of property, more than 80% of the value of its assets are readily marketable stocks or securities held for investment purposes.

¹² “Investment partnership” here means any partnership that has never been engaged in a trade or business and substantially all of the assets of which have always consisted of stock in a corporation, notes, bonds, or debentures, foreign currencies, derivatives, commodities traded on exchanges, and similar assets. A partnership will be deemed to have engaged in a trade or business if it conducts that business through another partnership. IRC § 731(c)(2)(C).

¹³ The profits interest may be held directly or indirectly through a tiered structure. IRS Reg. §1.1061-1(a).

In addition, the TCJA made changes to the rules for how such income is treated—limiting the ability of tax-exempt entities to offset income and losses and to carry forward and use losses in subsequent years. IRC § 512(a). Those changes focused on income from partnerships using debt to finance certain investments. See IRC § 514. The IRS has subsequently issued guidance limiting the application of these provisions, allowing aggregation and offset of gains and losses from similar activities. See IRC § 512(c), IRS Notice 2018-67, and proposed regulations in Notice. 85 Fed. Reg. 23172 (Apr. 24, 2020).

The bottom line, however, is that a tax-exempt entity may have unrelated business income or loss as a partner in a partnership that generates such income. If so, the entity must treat its share of the partnership income or loss as if it had conducted the business activity itself. There is generally no distinction is made between limited and general partners or managing or non-managing members of a limited liability company for this purpose. Also, tax-exempt entities must notify the partnership of their tax-exempt status. The partnership is then required to provide the organization this information on Schedule K-1.¹⁴

Effectively Connected Income and Effect on Foreign Partners

Foreign persons may have U.S. source income, including income from U.S. partnerships. That income is generally divided into two categories – effectively connected income (ECI) and fixed, determinable, annual, or periodical income (FDAP). Both are subject to U.S. tax, but the treatment varies.

What may be especially important for our purposes is a change made in the TCJA which now clearly sources the gain (loss) from the sale of partnership interests to the U.S. in certain circumstances. A direct or indirect foreign partner in a partnership engaged in (or is treated as engaged in) a trade or business in the U.S. will have effectively connected gain (loss) sourced to the U.S. when the interest in that partnership is sold. IRC §864(c)(8). The amount subject to tax in the U.S. is limited to the gain (loss) that would have resulted had the partnership sold all of its assets at fair market value on the date the interest is sold.¹⁵

Publicly Traded Investment Partnerships

Ordinarily, publicly traded partnerships—that is entities formed as partnerships whose interests are traded on a public exchange—are taxed as corporations. However, certain partnerships that engage primarily in investment activities may be publicly traded but taxed as partnerships. See IRC § 7704.

To qualify to be taxed as a partnership, a publicly traded partnership must have 90% of its income from certain sources—including interest, dividends, real property rents, gain from the sale of real property, income and gains derived from the exploration, development, mining or production, processing, refining, transportation, or the marketing of any mineral or natural resource, and income and gains from certain commodities. Publicly traded investment partnerships taxed as partnerships are subject to the substantive rules discussed in this section.

Non-Partnership Investment Entities

As discussed in Section II, investment partnerships are generally not regulated (although their managing partners may be). Certain regulated investment entities (e.g. mutual funds) are organized as corporations, not partnerships, and are subject to a hybrid form of pass-through taxation. See IRC § 851. As summarized in Section III below, some states have tied their definition of a qualifying investment partnership to the definition of a regulated investment company under § 851.

¹⁴ See also IRS Publication 598, “Tax on Unrelated Business Income of Exempt Organizations,” available here: <https://www.irs.gov/pub/irs-pdf/p598.pdf>.

¹⁵ See also IRS Publication 519, “U.S. Tax Guide for Aliens,” available here: https://www.irs.gov/publications/p519#en_US_2021_publink100016946.

Effects of Federal Conformity on State Taxation

The federal system to which states conform creates complexities that states must deal with. Not only does the system include critical substantive rules that may lead to very different tax treatment of partnership items, it also splits the responsibility for tax reporting and tax payment between the partnership and its partners and permits large, complex tiered partnership structures and flexible income sharing arrangements, in which partners share different partnership items in different proportions (called “special allocations”). These structures and arrangements may have valid business purposes, but they also provide opportunities for tax avoidance and abuse and can greatly multiply tax enforcement problems.¹⁶ These structures and arrangements are features of investment partnerships, as well, as this paper will outline in Section II.

Nor can states rely on the federal government for adequate enforcement. This same complexity has created problems even for the IRS. One of the most comprehensive studies of passthrough tax information is, “Business in the United States: Who Owns It and How Much Tax do They Pay?”, published in 2016 by the U.S. Treasury Department.¹⁷ That study used detailed federal tax return data from partnerships (including those engaged in investment activities) and partners to determine both the source of the income and the taxpayers that ultimately received it. But despite having access to detailed tax information, it found this tracing was difficult, in part, due to the complex partnership structures involved, noting (at page 3):

Partnership ownership is not only concentrated, but also opaque. First, twenty percent of partnership income is earned by partners that we have not been able to classify in administrative data. Second, following money through partnership structures—between the partnership generating the income and the ultimate owners taxed on that income—proves challenging as well. We develop an algorithm that recursively traces income through partnership structures to ultimate non-partnership owners and attempts to assign that income back to an originating partnership. This recursive algorithm reaches a fixed point before all partnership income has been successfully assigned: fifteen percent of income is in circular structures and cannot be uniquely linked to an originating partnership. Together, the union of income flowing (1) to unclassifiable partners and (2) through circular partnerships amounts to \$200 billion or thirty percent of income earned in the partnership sector overall.

And to quote the 2016 Study at pages 20-21:

After our recursive algorithm reaches a fixed point, there remain 22,417 ‘circular’ partnerships for which we cannot uniquely link all income to non-partnership owners. These [opaque] partnerships issue 9.6 million K-1s. To put this activity’s scale in perspective, our entire K-1 population file includes 25.5 million K-1s issued by 3.6 million partnerships. Thus, less than 1% of partnerships issue nearly 40% of K-1s. Some of these partnerships issue more than 100,000 K-1s.

So states that conform to the federal passthrough system also take on the burdens of this complexity.

But conformity to the federal passthrough system and substantive tax rules is only a part of the existing state partnership tax system. States must also develop rules for dividing the income of multistate partnerships. State sourcing of partnership items is covered in Section I.B, below. And, while this sourcing process is somewhat more complicated for partnership income and items taxed on a passthrough basis, it is the principled application of the rules to tiered partnership structures, in particular, that states may struggle with—and this may also affect investment partnerships even when they are subject to simplified sourcing rules in their home state.

In response to the complexity of the passthrough system and problems it creates for verifying and tracking income, states have developed certain enforcement tools that have become an important component of the state partnership tax system. These tools may, in turn, have critical effects on the way partnership items are ultimately sourced and taxed, and will be described briefly in Section 1.C, below.

¹⁶ See Gregg D. Polsky and Emily Cauble, “The Problem of Abusive Related-Partner Allocations,” 16 Fla. Tax. Rev. 479 (2014), available at: https://digitalcommons.law.uga.edu/fac_artchop/1086.

¹⁷ Available on multiple public sites, including here: <https://www.mtc.gov/MTC/media/Partnership/NYU-2016-Business-in-US-Analysis-of-tax-paid.pdf>.

I. B. State Sourcing Rules

Multistate income must be divided or “sourced” for state tax purposes. Sourcing methods vary somewhat by state. Sourcing of partnership income may depend on the type of partnership, the type of income, or the type of partner. This Section I.B. provides an overview of the generally applicable methods for sourcing partnership income. This information will be critical to understanding the specific rules used by some states for sourcing the income of certain investment partnerships—set out in Section III.

The following topics are covered in this Section I.B:

- Traditional sourcing treatment of investment income
- General state sourcing methods for partnerships
- Sourcing methods applied in the case of including individual, corporate, and tiered partners
- Sourcing gains (losses) from sales of partnership interests
- Effect of state sourcing of income, gains, and losses on allowable offsets
- Effect of “blocker” corporations on state sourcing
- Effect of entity-level taxes on state sourcing

Traditional Sourcing Treatment of Investment Income

States may tax nonresident individuals on their income derived within the state.¹⁸ Traditionally, this has included income from active businesses in the state. But it has also included income from use or investment in property in the state.¹⁹ Certain passive investment income, however, was often sourced to the investor’s state of residence—including dividends, capital gains, or interest arising from securities such as corporate ownership shares. Exceptions include taxes imposed directly on distributions or dividends made to corporate shareholders where the corporation is required to withhold or pay.²⁰

As described in Section III below, a majority of states appear to have explicitly applied a similar distinction to sourcing of partnership income. In these states, partnership income that is from owning or using property or from business activity in the state is sourced to the state using generally applicable methods (discussed further below). But partnership income that is purely from passive investments is simply sourced to the partner’s residence—as it would be if the investments were held directly by the partners.

To evaluate this sourcing of investment partnership income and when it may or may not apply, it is first necessary to understand the general partnership sourcing rules applicable to partnership income. Even where an investment partnership is subject to special sourcing in its home state, it may hold investments in other states where the income from those investments would be sourced differently.

General State Sourcing Methods

States use two main sourcing methods for multistate income—specific assignment and formulary apportionment.²¹ These methods have been most extensively developed for taxing multistate corporations at the entity level. Both methods have long been incorporated into the Uniform Division of Income for Tax Purposes Act (UDITPA),²² on which most state rules are based.²³ Understanding the general methods, and the principles behind these methods, is especially important for sourcing partnership income since—given the complexity of sourcing income taxed under the passthrough system—states may lack specific

¹⁸ *Wisconsin v. JC Penney Co.*, 311 US 435 (1940).

¹⁹ See, for example, *New York ex rel. Whitney v. Graves*, 299 US 366 (1937).

²⁰ See, for example, *International Harvester Co. v. Wisconsin Dep’t of Tax’n*, 322 US 435 (1944).

²¹ States sometimes use different terms for these methods.

²² Available here: <https://www.uniformlaws.org/committees/community-home?CommunityKey=f2ef73d2-2e5b-488e-a525-51be29fbee47>. See also the MTC’s recommended version of UDITPA, here: <https://www.mtc.gov/Uniformity/Article-IV>.

²³ The MTC has developed detailed regulations for its proposed version of UDITPA. See the Model General Allocation and Apportionment Regulations (hereafter, MTC model regulations) – available here: <https://www.mtc.gov/MTC/media/AUR/FINAL-APPROVED-2018-Proposed-Amendments-042020.pdf>.

rules addressing every situation. So, the application of sourcing methods will depend on the application of these general principles.

Specific Assignment

Specific assignment can be thought of as a traditional sourcing method—most commonly used at the international level, including by the federal government. See IRC § 861-865. Specific assignment sources individual items of income, expense, gain, and loss by applying different rules based on the specific characteristics and attributes of each item and the activity to which the item relates—e.g. sourcing rents to the locations (s) where the property is located—including by use of discrete ratios.

Formulary Apportionment

Formulary apportionment, as the term is used in this white paper, refers to a specific method designed to apply not to discrete items of income but as the means of sourcing a taxpayer’s entire multistate net income (loss).²⁴ Formulary apportionment identifies certain elements or “factors” of a taxpayer’s multistate operations giving rise to this net income—typically total sales, property, and/or payroll—and then determines the ratio of those factors that are located in the taxing state. This general ratio is then applied to the taxpayer’s total multistate net income to compute the amount derived from the state.

Constitutional Limits on Use of Formulary Apportionment

Formulary apportionment is the primary sourcing method used by states. But constitutional principles impose certain limits. In brief, items of income (or expense) that make up the apportionable base must have a sufficient connection to the taxpayer’s operations and to the factors used to apportion that base.²⁵ This connection is generally referred to as a “unitary” connection. We refer to the items that lack this unitary connection as “non-apportionable.”²⁶ Non-apportionable items should be distinguished from those that may result from a separate business of a single taxpayer to which a separate formula and ratio might be applied.²⁷ Non-apportionable items are generally sourced using rules of specific assignment.²⁸

Sourcing Methods Applied to Partnerships - Generally

As discussed further below, since it is the partners who will ultimately report and pay tax on their shares of partnership items, partnerships must provide their partners with specific state sourcing information. Also, the nature of the partner—whether individual, corporation, or tiered—may affect sourcing. Tiered partnership structures, in particular, present sourcing questions not fully addressed by state rules—and can also affect the sourcing of the income and items of investment partnerships.

Partnership Information Reporting

For partnership items subject to the general sourcing methods discussed further below, partnerships must provide partners with the necessary sourcing information. This information may take one of two forms, depending on particular state requirements and whether the partner is an individual, corporation, or tiered partner (and in some cases whether the partner is tax-exempt). The partnership may simply provide the state-sourced amounts of the partners’ shares of partnership items as determined at the partnership level. Alternatively, the partnership may provide information required to compute the state-sourced amounts of those shares. In addition to reporting this information to partners, states may require that partnerships also report this sourcing information as part of their partnership returns (including withholding information, discussed further in Section I. C below).

²⁴ See *Underwood Typewriter Co. v. Chamberlain*, 254 U. S. 113 (1920), and *U.S. Steel Corp. v. Multistate Tax Comm’n*, 434 U.S. 452, 473 (1978).

²⁵ See *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992). MTC Model Regulations, supra FN 23, incorporate unitary principles. See Reg. IV.1.(b). pages 18-22.

²⁶ Items that may be sourced using formulary apportionment versus items that may not, are referred to using various terms including “operational” versus “investment,” and “business income” versus “nonbusiness income.” The MTC’s recommended version of UDITPA uses the terms “apportionable income” versus “non-apportionable income,” tying their definition directly to the constitutional standard.

²⁷ See MTC Model regulations, supra FN 23.

²⁸ See UDITPA, supra FN 22, Sec.s 4-8.

Sourcing for Individual Partners

An individual partner must file and pay tax on partnership items in states where the partnership operates and in the partner's state of residence.

- Reporting in Nonresident States – In the states where the partnership operates but the partner is a nonresident, the partner will pay tax on the partner's share of the amounts of state-sourced partnership items,²⁹ whether sourced using formulary apportionment or rules of specific attribution, applying the partnership's sourcing information at the partnership level. (Taxable trusts are often treated as nonresident partners.)
- Reporting in Resident State – In the partner's state of residence, the partner typically reports tax on 100% of the partner's income regardless of the source. The partner may then take a credit for tax paid to other states on that same income, including partnership items, with certain limitations.³⁰

Sourcing for Corporate Partners

Unlike individual partners, corporate partners generally do not report 100% of their multistate income to their state of domicile—instead applying the general sourcing rules to that income in every state. But sourcing a corporate partner's share of partnership items is complicated by the fact that corporations, unlike individuals, have their own sourcing information, including apportionment factors. States must therefore decide whether to source items using the partnership's sourcing information, the corporate partner's information, or some combination. States may use alternative approaches in applying both the formulary apportionment and specific assignment sourcing methods to corporate partners, as described below.

Formulary Apportionment – Alternatives:

The three basic alternatives for applying formulary apportionment to the partnership items of corporate partners include:

- Blended Apportionment – The corporate partner includes its share of apportionable partnership items in its apportionable net income. It then computes a blended apportionment ratio by including a similar share of partnership apportionment factors with its own factors in computing that ratio. This blended ratio is then applied to the apportionable income. This appears to be the most commonly used approach.³¹
- Corporate-Level Apportionment – The corporate partner simply includes its share of apportionable partnership items in its apportionable net income, but does not include any share of partnership factors in computing its apportionment ratio. This approach might be allowed where the corporate partner lacks the necessary partnership information.
- Partnership-Level Apportionment – The corporate partner's items are sourced using the partnership's general apportionment ratio. This is similar to the approach used by nonresident individual partners (above). Sometimes referred to as “look-through” or “investee apportionment,” this method might be used where the corporation has no other income derived from the state, especially where the tax is administered through withholding at the partnership level. This approach may also be used as a rule of specific assignment. (See further discussion below.)

All things being equal, the actual amount of the corporate partner's partnership items sourced to the state will vary depending on which of these methods is used.

²⁹ States may also have partnership “withholding” requirements or elections for partnerships to pay tax for partners.

³⁰ See *Comptroller of Treasury of Md. v. Wynne*, 575 U.S. 542 (2015). One common limit is that the credit cannot exceed the amount that would be due if the resident state's own tax rate were applied. Some states also limit the credit to the amount that would have been paid if the taxing state had used sourcing rules compatible with the resident state's own rules. But states might also simply apportion the business income of resident partners in the same way they do the income of nonresidents or corporations. See, for example, New Mexico's approach – N.M. Stat. Ann. § 7-2-11.

³¹ See the MTC's models for combined corporate reporting, both of which take this approach. here:

https://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_Z/Combined%20Reporting%20-%20FINAL%20version.pdf; and here: <https://www.mtc.gov/Uniformity/Project-Teams/Model-Statute-for-Combined-Filing-Finnigan-Adp.aspx>.

Application of Specific Assignment – Alternatives:

Items earned or incurred by a partnership may be apportionable in the hands of the partnership, but non-apportionable in the hands of the corporate partner—that is, they may bear a sufficient connection to the partnership’s general apportionment factors, but not to the corporate partner’s factors. Alternatively, partnership items might also be non-apportionable in the hands of the partnership—so that it would not be proper to apply the partnership’s apportionment factors to source the items.

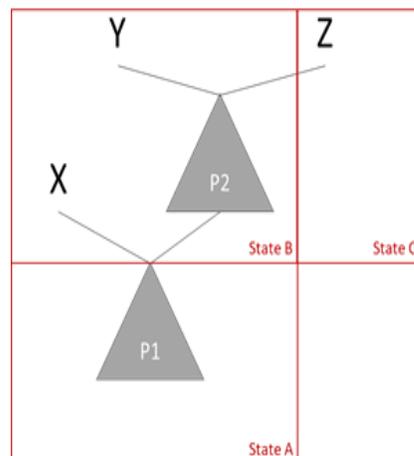
- Items Non-apportionable Only at Corporate Partner Level – As noted in the discussion of formula apportionment alternatives above, an approach to sourcing partnership items that are considered non-apportionable in the hands of the corporate partner, but not the partnership, is to use partnership-level or “investee” apportionment (similar to the method used by nonresident individuals).
- Items Non-apportionable at Partnership Level – Items that bear no relationship to the partnership’s own apportionment factors might be sourced using rules of specific assignment applied at the partnership level. This state-sourcing information would pass through to the corporate partner and be used to source the partner’s share of that item. Or states may provide other alternatives.

Tiered Partners

As with corporate partners, when partnerships have other partnership as partners, (“tiered partners”), this complicates the application of the general state sourcing methods, multiplying the number of potential alternative approaches that could be used. States sometimes lack specific rules indicating which approach to apply, and application of general principles to particular facts may not always point to the same approach. Take the very simple example below.

Example – Tiered Partnership Sourcing:

- P1 is a partnership operating a business entirely in State A (which imposes an income tax).
- Initially, P1 has two partners—X and Y both residents in State B (which has no income tax).
- X and Y recruit Z, a corporation doing business in State C, to contribute to P1’s business.
- Rather than having Z contribute to and receive an interest in P1, Y and Z form P2. Z contributes to P2, and Y contributes his interest in P1 in exchange for his interest in P2.
- P2 has its operations entirely in State B.
- So P1 is owned by X and P2, and P2 is owned by Y and Z.



Assume P1 generates ordinary income of \$1 million. Shares of that income are allocated to its partners, X and P2. P2 then allocates shares of its income, including its share of P1 income, to partners, Y and Z.

How might Y’s indirect share of the P1 income be sourced? There are at least three alternatives:

- Using an apportionment ratio including only P1’s apportionment factors, applied to Y’s indirect share of P1 income.
- Using an apportionment ratio including only P2’s apportionment factors, applied to Y’s share of total P2 income (including P2’s share of P1 income).
- Using a blended apportionment ratio including P2’s factors and a share of P1’s factors, applied to Y’s share of total P2 income including P2’s share of P1 income.

And how might Z’s indirect share of this income be sourced? Here, because Z is a corporation and has its own apportionment factors, there are at least six alternatives. First, there are the three general approaches described above (which would not involve the use of Z’s own apportionment factors). But then there are three additional methods:

Z could include its share of P2 income (including P2's share of P1's income) in Z's apportionable income and apportion that total amount:

- Using Z's apportionment factors alone,
- Using Z's apportionment factors blended with a share of P2's, or
- Using Z's apportionment factors blended with a share of P2's and P1's.

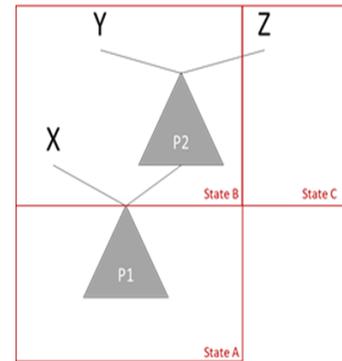
What principles should be applied to choosing between these approaches? We might need additional facts—such as whether P2 is essentially a holding company, whether P1's income otherwise has a unitary connection to P2's factors, or whether Z is a passive or active partner.

Effect of Tiered Structures on the Sourcing of Income of Qualified Investment Partnerships

Questions as to how items should be sourced through tiered partnership structures are relevant even for investment partnerships that may qualify for special sourcing methods in some states. Investment partnerships, broadly defined, are often formed in tiered structures and may also hold investments in other partnerships. These multi-tiered structure may also operate in multiple states. (See Section II, below.) This means that the special rules for sourcing their income in one state may not apply in other states.

Take the example discussed above and make two modifications:

- Assume that State B has an income tax and a rule for investment partnerships allowing the income from those partnerships to be sourced solely to residence or domicile, and
- Also assume that P2, qualifies as an investment partnership under this rule. In that case, you might conclude Y's share of income from P2, including the income passing through from P1, would be sourced to State B, and Z's share would be sourced to State C.



Of course, whether States A or C might tax the income from P1 would not necessarily depend on the rule in State B, but on the rules in States A and C. If State A were to require that the income of P1 be sourced to State A, including any shares allocated to indirect partners, then the fact that this income flows through P2 in State B would not change that determination.

Now assume State A also had a special sourcing rule for investment partnerships identical to State B's. Even then, depending on how that rule is drafted, State A might tax Y and Z's indirect shares of P1 income, since P1 is not an investment partnership. Similarly, if State C requires that corporations apportion all partnership items, like Z's share of income from P2 (including Z's share of P2's share of P1 income), using a blended apportionment factor, then presumably Z would use this method when filing and paying tax in State C, regardless of the special sourcing rule that might apply in States A or B.

In short, because partnerships engaged in investing often do so through tiered structures which invest in other partnerships, operated on a multistate basis, income flowing through such partnerships may not always be sourced to its partners' states of residency or domicile, even if that income would be subject to a special sourcing rule in the investment partnership's home state.

Sourcing Gains (Losses) from Sales of Partnership Interests

So far in this Section I.B, the discussion of state sourcing rules has focused on the tax items recognized by partnerships and passed through to partners. Partners may also recognize gains or losses from the sale of their partnership interests. When a partnership interest is sold, the gain is not a partnership item of the partnership that is sold and doesn't pass through that partnership to its partner. Rather, the gain is recognized directly by the partners.³²

As discussed further in Section II, investment partnerships (defined broadly) often hold interests in other partnerships and therefore may have significant gains from sales of those interests. States also have dif-

³² Gains may also result from distributions in excess of the partner's outside basis. See IRS Reg. § 1.731-1.

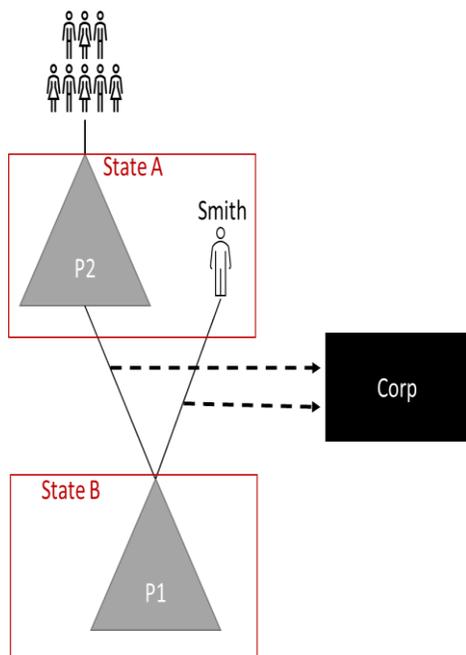
ferent general rules for sourcing gains (losses) from sales of partnership interests, which may depend on whether the ultimate taxpaying partner is a corporation or individual.

As illustrated below, these differences may also affect partners of an investment partnership, even if that partnership otherwise qualifies for special sourcing in its home state.

Corporate and Individual Partners

In the past, disputes over sourcing of these gains from sales of partnership interests focused on corporate partners and whether the gain (or loss) was “business” or “nonbusiness” income under UDITPA or similar rules.³³ If the gain was business income, it was included in the corporate partner’s apportionable net income and apportioned using the corporate partner’s factors or a blended ratio.³⁴ If it was nonbusiness income, it was typically sourced to the taxpayer’s domicile under the rules of specific assignment in UDITPA Section 6(c), or similar rules.

What has been less clear is how states might source gains from the sale of partnership interests by nonresident partners. Most states appear to simply source such gains to the partner’s state of residence. Individuals lack apportionment factors, so any apportionment of the gain would have to be based on the transferred partnership’s own factors, or its assets. This approach is similar to the sourcing of partnership items by individuals in nonresident states, discussed above. Today, about a dozen states use this method of sourcing these gains, sometimes called “investee apportionment.”³⁵ This method may also be used to source gains treated as non-apportionable income by corporate partners.



Tiered Partners – Including Investment Partnerships

And what about partnership partners? A simple example (depicted, left) illustrates the issue. P1, a partnership, operating entirely in State B has two partners—P2 (another partnership) and Smith. P2 and Smith each sell their interests in P1 to Corp for a gain.

Assume State B uses “investee apportionment,” requiring the gain to be sourced to that state based on P1’s apportionment factors. Smith would report the gain in both State B and State A (residence), and claim a credit in State A for taxes paid.

What about P2—how would its partners source the gain? Presumably, under State B’s rule, P2’s partners would also source their shares of P2’s gain to State B. But State B, might instead treat P2 as a qualified investment partnership—sourcing its income, including the gain, to its partners’ residence/domicile. Note that this would depend on the definition of a qualified investment partnership that B uses. The fact that State A has an investment partnership rule would not necessarily affect how State B might source or tax the gain from the sale of P1.

And finally, as with any items of income—if the gain here flowed through additional partnership tiers before reaching taxpaying partners, the methods for sourcing items through tiered structures, described briefly above, might alter the state(s) to which the gain is sourced.

³³ See, for example, *Ex parte Uniroyal Tire Co.*, 779 So. 2d 227 (Ala. 2000).

³⁴ That is, some portion of the transferred partnership’s factors—or the gain itself—might be included in the computation of the apportionment factor of the corporate partner. See MTC model regulations, *supra* FN 11, Reg. IV.18.(c), which addresses this issue generally.

³⁵ Disputes involving this approach are ongoing and have focused on whether it is consistent with constitutional limits. See, for example, *Corrigan v. Testa*, 2016-Ohio-2805, 73 N.E.3d 381 (2016); *Noell Indus., Inc. v. Idaho Tax Comm’n*, 167 Idaho 367, 470 P.3d 1176 (2020); and *VAS Holdings & Investments, LLC v. Commissioner of Revenue*, Massachusetts Appellate Tax Board, Tax Appeal Decision, No. C332269 (2021). And see also Walter Hellerstein, “Substance and Form in Jurisdictional Analysis: *Corrigan v. Testa*,” Tax Notes State, Jun. 13, 2016, available here: [https://www.mtc.gov/MTC/media/Partnership/Hellerstein-\(June-13,-2016\).pdf](https://www.mtc.gov/MTC/media/Partnership/Hellerstein-(June-13,-2016).pdf).

Effect of State Sourcing of Income, Gains, and Losses on Allowable Offsets

As discussed in Section I.A above, taxpayers may generally offset income, gains, and losses from different sources within limits (and may carry forward unused losses). Like other forms of investment or portfolio income, the gains and losses generated from the sales of partnership interests, discussed above, may generally be offset as capital gains and losses (either long-term or short-term) in computing federal taxable income—not limited by passive loss rules. Corporate partners that include such gains and losses in their apportionable income would also offset those gains and losses against other capital gains and losses in computing their apportionable base. Similarly, individual partners filing in their state of residence would generally be able to offset investment gains and losses in computing the partner’s tax in that state.

But for nonresident individual partners or corporate partners treating certain gains and losses as non-apportionable income, the offset of these capital gains and losses in computing income in a particular state would depend on the portions of the gains and losses sourced to the particular state. So, for example, assume Partner A, an individual, has investment gains that would be sourced to State 1 and investment losses that would be sourced to State 2. Partner A would generally be able to offset these gains and losses when filing in her state of residence, but would file separately in State A—reporting just the gains, and in State B—reporting just the losses.

Effect of “Blocker” Corporations on State Sourcing

As noted in Section I. A above, “blocker” corporations may be used to prevent tax-exempt investors from having to pay tax on UBI and foreign investors from having to report and pay U.S. tax on ECI. Instead of the tax exempt entity or foreign individual investors holding interests in a partnership that, in turn, invests in other portfolio companies, a blocker corporation holds the partnership interest and the investors hold shares in the blocker corporation. The corporation pays the tax on items of income from the investment partnership—a separate cost that will ultimately affect the amount of profits available for distribution to the owners. But while there is an additional layer of tax, those corporate distributions will be treated as investment income to both the tax-exempt entity and foreign individual, effectively insulating those shareholders from the effects of any UBI or ECI that might be associated with the lower-tier or portfolio company. The blocker corporation would also shield the foreign investor from the need to report and pay tax on any gains from the sales of partnership interests in U.S. partnerships under IRC § 864.

Blocker corporations can also be used to simplify the state sourcing, reporting, and payment of tax on partnership income.³⁶ Use of such entities would potentially allow offsetting of income, gain, and loss that, for non-resident individuals, might be sourced to separate states and, therefore, not be subject to netting in calculating the taxes in those separate states. But it also appears that no states have specifically addressed the use of blocker corporations or how their use might otherwise affect sourcing of any underlying partnership income.

Effect of Entity-Level Taxes on State Sourcing

As noted in Section I.A above, states have adopted different forms of entity-level taxes for enforcement purposes (i.e. withholding), convenience (i.e. composite return elections), and to allow their residents to avoid the TCJA’s federal cap on the deduction for state and local taxes (so-called “PTE taxes”). Use of entity-level taxes for enforcement purposes is discussed further in Section I.C below. Again, while investment partnerships that are subject to special sourcing treatment in a state may also be excluded from entity-level taxes in that state, it may nevertheless be the case that the portfolio companies in which those partnerships are invested are operating partnerships and are not excluded from such taxes in the states where they operate.

Entity-level taxes can also effect the sourcing of income subject to state tax. As summarized above, the application of state sourcing rules may depend on whether the partners to whom those items are allocated are resident or nonresident individuals or corporations, and whether the items pass through tiered partners. But an entity-level tax cannot easily take into account the blended apportionment ratios that

³⁶ See Carolyn Joy Lee, Bruce P. Ely, and Dennis Rimkunas, “State Taxation of Partnerships and LLCs and Their Members,” *Journal of Multistate Taxation and Incentives* (WG&L), Feb. 2010, available here: <https://www.bradley.com/-/media/files/insights/publications/2010/02/state-taxation-of-partnerships-and-llcs-and-their/files/reprint/fileattachment/state-taxation-of-partnerships-and-llcs-and-their.pdf>.

might be used where the partners are corporations or where the items flow through a tiered partnership structure to the ultimate taxpaying partners. So an entity-level tax may effectively change the sourcing.

Entity level taxes also raise questions as to whether individual partners can claim a credit for taxes paid in that partner's state of residence. States often impose general limits on such credits. But relevant for this purpose is the statutory language of many of these credit provisions, which make the credit available only to the resident "taxpayer" who properly "pays the tax" on his or her own income to another state.³⁷ Assuming the state's credit provision is internally consistent—that is, assuming it would give its residents a credit that represents the extent to which it would tax nonresidents on similar income—it need not give any additional credit. Nevertheless, failing to credit residents for entity-level taxes may ultimately undercut the general usefulness of those taxes, including for enforcement, on a multistate basis.

I.C. Necessary Enforcement Mechanisms

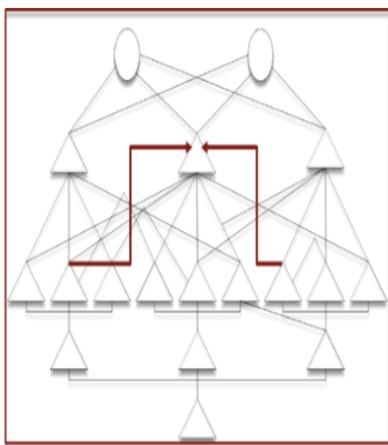
Discussions in Sections I. A. and B above make clear that combining the complex federal passthrough system with the general state sourcing rules creates not only complexity and uncertainty, but also potential compliance and enforcement problems. States have therefore incorporated essential enforcement mechanisms to address these problems. These mechanisms may also affect the tax due.

States that provide special sourcing treatment of investment partnership income sometimes exclude qualified investment partnerships from particular enforcement mechanisms. But it would be a mistake, to assume that investment partnerships or their income will never be subject to these types of enforcement mechanisms. Indeed, even in states that have adopted special sourcing rules for investment partnership income, the partnership may still be subject to detailed information reporting requirements. Also, as discussed in Section I.B above, just because a partnership may qualify for special sourcing treatment in its home state, does not mean that it will qualify under the laws of every state in which it operates. Moreover, such partnerships may have holdings in other partnerships, and the income that flows up from those partnerships may be subject not only to the general state sourcing rules but also to any state-level enforcement mechanisms.

The topics covered in this section include:

- The role of federal enforcement mechanisms
- The role of state enforcement mechanisms
 - State information reporting
 - State auditing
 - State entity-level impositions
 - Add-back statutes

Role of Federal Enforcement Mechanisms



Because states conform generally to federal substantive rules and to the federal passthrough system, they depend upon the IRS to enforce the proper reporting of partnership tax items. It has become increasingly apparent, however, that the IRS has not had the tools necessary to deal with large, complex partnership structures or with the flexibility allowed by Subchapter K in using diverse income-sharing arrangements.

The diagram at right depicts a tiered partnership structure that also includes circular ownership relationships between the tiered partners (shown by the red lines). As was discussed in Section I.A above, such structures may make tracing income exceedingly difficult, even with properly filed information reports. (Of course, these complex structures pose compliance burdens for taxpayers too—but taxpayers control the complexity of the structures they create.)

³⁷ See *Individual Taxpayer (Redacted) v. Maine Revenue Services*, Docket No. BTA-2020-1 (Bd. Tax. App. Mar. 1, 2021).

Federal Information Reporting

To demonstrate compliance with federal substantive provisions and the requirements of Subchapter K, partnerships must increasingly use more detailed record-keeping and tracking methods, and must also comply with increased information-reporting requirements.³⁸ The IRS is also reported to be developing enhanced tools to evaluate the information filed in order to identify potential problems.³⁹

Federal Centralized Partnership Audit Regime

Information-reporting, alone, is insufficient to ensure compliance. However, the IRS has been unable to conduct regular partnership audits of large partnerships. This led Congress to pass the federal Bipartisan Budget Act of 2015 giving the IRS substantial new authority to audit and assess taxes at the partnership level.⁴⁰ This centralized partnership audit regime shifts to the partnership much of the burden of proving that the proper tax was paid by taxpaying partners.⁴¹ The IRS has only recently initiated audits under this program, so its effectiveness is still unknown.⁴²

Federal Withholding on Foreign Partners

Partnerships with effectively connected income must withhold tax on the share of that income allocable to foreign partners. A partnership determines if a partner is a foreign partner based on a certification of the partner. The tax rate is typically the highest federal rate. Publicly traded partnerships, in contrast, withhold tax on actual distributions of effectively connected income. And FDAP income is subject to a 30% withholding. Also, under IRC § 1446(f)(1), a transferee of an interest in a partnership must now withhold 10% of the amount paid for the purchase of a partnership interest subject to IRC § 864(c)(8). If the transferee fails to withhold, the partnership must deduct and withhold from distributions to the transferee the amount the transferee failed to withhold (plus interest).⁴³

Role of State Enforcement Mechanisms

Even effective federal enforcement won't ensure that partnership income is properly sourced, nor will it guard against strategies aimed primarily at avoiding state, rather than federal taxes. States, therefore, must have their own enforcement tools. These tools are often focused on ensuring that nonresident partners, including indirect partners, report partnership items properly sourced to the state.

State enforcement mechanisms include: (1) information reporting, (2) auditing, (3) entity-level impositions (including partnership "withholding"⁴⁴), and (4) so-called "add-back" statutes. In addition to contributing to enforcement, entity-level taxes and add-back statutes may also effectively override the passthrough system or alter how the partnership income is sourced and taxed.

\State Information Reporting

State information reporting requirements—including returns filed with the state and the reports required to be provided to partners—are fundamental to making the state passthrough system work and to ensuring that sourcing rules are properly applied. These information reporting requirements vary considerably

³⁸ See IRS tax basis capital account reporting requirement information in the IRS website, here: <https://www.irs.gov/newsroom/irs-releases-draft-form-1065-instructions-on-partner-tax-basis-capital-reporting>; and new reporting required for foreign income, here: <https://www.irs.gov/forms-pubs/changes-to-the-2021partnership-instructions-for-schedules-k-2-and-k-3-form-1065>.

³⁹ See "The Case for a Robust Attack on the Tax Gap," U.S. Treasury Dep't, Sep. 7, 2021, available here: <https://home.treasury.gov/news/featured-stories/the-case-for-a-robust-attack-on-the-tax-gap>.

⁴⁰ See "Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency," U.S. Government Accountability Office, GAO-14-732, Sep. 18, 2014, available here: <https://www.gao.gov/products/gao-14-732>.

⁴¹ See the IRS BA Centralized Partnership Audit Regime webpage, here: <https://www.irs.gov/businesses/partnerships/bba-centralized-partnership-audit-regime>.

⁴² See memorandum of Theodore D. Setzer, Re: Interim Guidance on Implementation of the Large Partnership Compliance Pilot Program, Oct. 21, 2021, available here: <https://www.irs.gov/pub/foia/ig/lmsb/lbi-04-1021-0017.pdf>.

⁴³ See information on these requirements on the IRS website, here: <https://www.irs.gov/individuals/international-taxpayers/partnership-withholding>.

⁴⁴ This tax is typically applied to net distributive share—which may or may not actually be distributed to partners.

state to state. States may provide general authority to the tax agency to establish detailed requirements for what information partnerships must file and provide to their partners.

State Auditing

As noted above, the passthrough system poses particular challenges for tax audits and eventually led to Congress granting additional powers to the IRS to audit large complex partnerships. For states the challenges are even greater, since these partnerships and partnership structures often operate in interstate commerce. But with only a few exceptions, states do not have a centralized partnership audit regime similar to the new IRS audit regime.⁴⁵ This, inevitably, puts pressure on other enforcement mechanisms.

State Entity-Level Impositions

As noted above, most states that tax partnership income provide for one or more entity-level taxes that may be imposed on that income including: withholding and estimated payments, composite return reporting, and so-called “PTE taxes.”⁴⁶ These entity-level impositions have different purposes, including enforcement. An entity-level tax has the enforcement advantage of re-connecting the tax reporting and tax payment functions separated by the passthrough system. But as noted in Sections I.A and I.B above, entity-level taxes may also change, fundamentally, the how the tax is determined and may also change the sourcing of partnership income for state tax purposes.

Entity-level taxes used for enforcement purposes are generally applied to the partnership’s net income amount—but only to the extent of the distributive shares of partnership items for included partners. And often the tax applies only to nonresident partners—so that the distributive shares of resident partners, corporate partners, or tiered partners are excluded from income subject to the entity-level tax. Exclusion of the distributive shares of tiered partners, in particular, limits the effectiveness of the entity-level tax as an enforcement tool. But including such partners may complicate the entity-level tax considerably.

Depending on their purpose (enforcement, ease of compliance, etc.), an entity-level tax may be mandatory or elective. Most states make withholding mandatory for nonresidents, but many still allow partners to opt out if they file a written “consent” to being taxed on their partnership income and agreeing to file a state return. Similarly, states may allow the partnership to file a so-called composite return for partners who wish to be included in that return. PTE taxes—a type of composite return tax—have also become common in recent years for other reasons, but are almost always elective.⁴⁷

Entity-level taxes may be imposed as a substitute for the taxes owed by the taxpaying partners—effectively exempting the partners from filing and reporting tax on distributive share on which the entity-level tax has been paid. Alternatively, they may act as withholding, or a pre-payment of the partners’ own tax, providing an offset credit of the tax owed by the partners in that state.

States may weigh the trade-offs between enforcement and the creation of these additional issues and decide that entity-level taxes are, on balance, worth it. But entity-level taxes may also exacerbate the risks of income shifting between states, created by the existence of complex multi-tiered partnership structures and intercompany special allocations or transactions. A detailed explanation of this problem is beyond the scope of this white paper. Suffice it to say, one partial solution to this problem is add-back provisions.

⁴⁵ See Georgia’s law allowing state audits of partnerships, GA L. 2018, Act 381 (HB 849) and Pennsylvania’s long-standing partnership audit regime, 72 P.S. §7306.2.

⁴⁶ Another situation in which entity-level taxes may apply is in the context of state taxes owed on federal partnership audit adjustments under the new IRS centralized audit regime. See the MTC model approach to this issue, here: [https://www.mtc.gov/MTC/media/Uniformity/AUR/Proposed-Model-RAR-Statute-Technical-Corrections-\(FINAL\).pdf](https://www.mtc.gov/MTC/media/Uniformity/AUR/Proposed-Model-RAR-Statute-Technical-Corrections-(FINAL).pdf).

⁴⁷ See a discussion of these PTE taxes in the Tax Notes-State article, “They’re All Different and That’s the Problem: State PTEs,” Steve N.J. Wlodychak, 2021, available here: [https://www.mtc.gov/MTC/media/Partnership/Wlodychak-Article-on-PTE-Taxes-\(08-02-2021\).pdf](https://www.mtc.gov/MTC/media/Partnership/Wlodychak-Article-on-PTE-Taxes-(08-02-2021).pdf).

State Add-Back Statutes

Partners may agree to special allocations of partnership items for a host of reasons—e.g. to compensate active partners for their roles or to give preferential returns of certain items to encourage investments. Partnerships may also engage in transactions with their partners, including tiered partners. These transactions are not allocations of partnership items. Rather, they give rise to partnership items (income, expense, gain, or loss). See IRC Sec. 707. So, for example, a partnership might purchase services from its tiered partner resulting in income to the tiered partner and an expense for the partnership. These intercompany allocations and transactions can lead to the same types of income-shifting that were prevalent in the state corporate income tax system, prior to combined filing.

These issues can affect state taxation of investment partnerships as well. Take a very simple example:

- Assume, that IP is a qualified investment partnership in its home state, so that under that state's sourcing rules—its income would be sourced entirely to the states where its partners reside or are domiciled.
- IP's only investment is a 60% holding in OP, which is not an investment partnership, operating in State X.
- Assume State X would not consider IP to be an investment partnership due to IP's holding of OP, and would source the income of OP to State X—requiring IP's partners to file and pay tax.
- Now assume, IP provides services to OP, for which it charges a fee, creating a deductible expense for OP. This reduces the taxable net income of OP subject to tax in State X and increases the income that may be sourced to the states of residence of IP's partners.

In some states, the definition of a qualified investment partnership would limit the amount of income the partnership receives in fees for services. But to address income shifting generally, states have often adopted rules requiring the “add-back” of income and expense from certain intercompany transactions, which might apply equally to related partnerships.⁴⁸

Section I. D. General Implications for Investment Partnerships

As discussed in Section I.A, the overarching principle of the passthrough system is that a partner's tax liability should be the same as if the partner engaged in the related activities directly. In addition, the federal substantive rules distinguish investment income and treat it differently for a number of purposes. States that conform to this federal system must consider the effects on state taxes generally and on the application of sourcing rules.

States generally source partnership items by looking to the relevant partnership activities and operations from which those items are derived. This is especially true for entity-level taxes, which have become more prevalent. And it appears to be a trend with respect to sourcing gain or loss from the sale of partnerships, as well. But traditionally, states have also sourced passive investment income to the investor's state of residence. So adhering to the principle that partners should be taxed as if they engaged in the activity directly would seem to counsel that there should be a separate rule for sourcing such income when derived from a partnership, so that it would be sourced to the partner's state of residence, as well. And this appears to be the rule adopted by the majority of states.

Nevertheless, drawing the line between what is investment and non-investment income is complicated by the fact that investment partnerships often invest in other partnerships that conduct general business operations. As a result, a special exception for the treatment of investment partnership income, if drafted too broadly, might swallow the rule. Also, investment partnerships and their portfolio companies operate in multiple states and conflicts between state rules can create problems for those partnerships and their partners.

⁴⁸ See, for example, the MTC's Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses, which includes partnerships and certain individuals in its definition of related entities, available here: https://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Add-Back%20-%20FINAL%20version.pdf.

SECTION II. INVESTMENT PARTNERSHIPS – DESCRIPTION OF THE INDUSTRY

NOTE: The summary description of common investment partnerships provided in this section is taken from multiples sources including information available on SEC and IRS websites and other government and industry sources, including published papers and reports, as well as private subscription sources such as Bloomberg Tax Portfolios and books on the topic. Critical sources are noted.

Purpose of this Section

Section I of this white paper described the state tax system for taxing partnership income, including federal conformity and the general state income sourcing principles commonly applied to multistate partnerships. Section III will contrast these general sourcing rules with the special sourcing treatment afforded to the income of certain investment partnerships.

The purpose of this Section II is to:

- Briefly describe the general categories of investment partnerships and their attributes and activities, and
- Summarize data from the IRS and industry sources on the size of partnerships that may designate themselves as being engaged in investment activities.

As will be discussed below, these partnerships are typically lightly regulated and there is often little public information available on them.

Section II. A. General Categories of Investment Partnerships

Investment partnerships must be distinguished from partnerships that may hold investments or that may have limited partners whose primary role is investing their capital. These facts alone do not make a partnership an “investment partnership” even in a broad sense—or if they did, virtually all but the smallest partnerships would be investment partnerships. Rather, it is the entity’s primary purpose and its overall activities that determine whether it is an investment partnership. Such entities typically limit their activities to investing in particular assets or other businesses, called portfolio companies, and may have other distinguishing characteristics as well.

The general descriptions and categories of partnerships discussed in this section may be similar to, but broader than the specifically defined category of partnerships that qualify for special state tax sourcing treatment in some states. This fact—that there are partnerships engaged in very similar activities with similar structures that may be subject to different treatment under state law—highlights the importance of carefully drafting applicable definitions and rules and doing so in a way that is consistent with any underlying policy rationales.

Form of Entity and Management

As the name amply implies, investment partnerships are formed not as corporations but as partnerships both under state law and for federal tax purposes. They are most often limited partnerships or LLCs—so that they have passive, limited partners or members as well as a general partner or managing member. This form distinguishes them from some other common types of investment entities—including regulated investment companies (corporations) and real estate investment trusts (trusts).

In non-closely held investment partnerships, the limited partner or managing member is typically a professional investment firm. That firm is also sometimes the “sponsor” of the investment partnership or “fund,” meaning that it recruits investors to contribute to the fund. Sometimes, the manager has affiliates that may provide additional services to the fund or to its portfolio companies. Often the manager and its affiliates enter into a separate partnership which then invests in the fund for this purpose and receives a profits interest.

Investment partnerships are often found in tiered partnership structures. This allows investors to diversify their investments, and it also allows fund managers and service providers to engage in activities related to multiple funds at the same time.

Assets and Income

The various regulatory and tax definitions of investment partnerships typically look to the types of assets held and the nature of the income generated. An asset test to define an investment partnership for a given purpose generally consists of the types of assets and the percentage they comprise of the total assets.

Assets may include (broadly):

- Securities, which are generally defined under applicable state and federal statutes. Under state law “securities” may include notes, stocks, futures, bonds, debentures, and similar representations of ownership including commodities and currency held for investment and “investment contracts” which term typically includes interests in a limited partnership, a limited liability company, or a limited liability partnership;⁴⁹
- Securitized debt;
- Real estate held for investment purposes;
- Other tangible or intangible assets held for investment, including works of art, copyrights, etc.

Income may be limited to income directly derived from these assets, and/or income may be limited in terms of its nature or tax character. Income categories that may be included are:

- Dividends or distributions;
- Interest;
- Rents and royalties;
- Capital gains; and
- Other passive income.

General Categories

Investment partnerships are typically categorized for general descriptive purposes as follows:

Private Equity Funds

Private equity funds are “closed-end” investment vehicles, meaning that there is a limited amount of investment that the fund will accept and interests are generally not traded. Private equity funds pool capital for investment in privately held businesses at various stages of development. Some funds diversify but many focus on particular sectors of the market or individual businesses. Private equity funds are often divided into subcategories:

- Angel funds which invest in start-ups;
- Venture capital funds which invest in more established businesses or technology;
- Leveraged buyout funds which invest in mature privately held businesses;
- Private label or captive funds which invest on behalf of a single investor; and
- Multi-manager funds which invest in other funds.

Often, investors in these funds have no liquidity, that is, they cannot sell their shares and must wait for any return until the fund sells its underlying investments.

Hedge Funds

Like private equity funds, hedge funds are not traded. But unlike private equity funds, hedge funds typically hold a range of different investment assets including publicly traded securities and may employ a number of investment strategies. They are typically focused on creating some amount of liquidity for investors seeking shorter-term investment returns.

Closely Held, Special Purpose, and Holding Company Partnerships

Closely held partnerships may be created for investment purposes or other related purposes for a number of reasons including economic, tax, or regulatory purposes. Closely held investment part-

⁴⁹ States have generally adopted some version of the uniform state law on securities, often called “Blue Sky Laws.” See the Uniform Securities Act of 2002 as approved by the Uniform Law Commission, available here: <https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=af36852d-457e-db56-3fc2-b2485cdc47e9&forceDialog=0>.

nerships may include related entities or persons, including family members. For example, family limited partnerships (FLPs) are often created to pass on a family business to the next generation while providing estate tax and other related benefits.⁵⁰ Certain special purpose entities (SPEs) or holding companies (HCs) organized as partnerships might also fall under a broad description of investment partnerships. For example, corporations may form a SPE or HC partnership or joint venture (treated as a partnership) to hold investments in other businesses.

Note that while a more comprehensive discussion of closely held investment partnerships and SPE/HCs is beyond the scope of this white paper, such entities may not be “investment partnerships” in the sense that the conduct investment activities. But suffice it to say, the broader a state’s tax definition of “investment partnership,” the more likely it will include these types of partnerships.

Investors

Investors in these partnerships are limited partners. Such investors may include accredited institutional or sophisticated private investors such as domestic and foreign high-wealth individuals, corporations, and certain tax-exempt entities. They may also include sovereign wealth funds, pension funds, and other governmental investors.

Regulation

Unlike mutual funds, investment partnerships are generally lightly regulated. The fund managers themselves may be regulated firms. But the funds may offer investments without significant regulatory oversight, in large part because the investors are typically sophisticated investors.

Section II. B. Investment Partnership Data

As noted above, there is little public information on individual investment partnerships and their activities. This section relies on IRS data, broken down by industry segment, and also on certain general investment industry reports.

Partnership Ownership Generally

The 2016 study, “Business in the United States: Who Owns It and How Much Tax do They Pay?”, published by the U.S. Treasury Department,⁵¹ discussed in Section I, attempted to trace income reported by partnerships to the ultimate taxpaying partners. Of the total of all partnership income that could be traced, the report found the biggest chunk went to U.S. individuals—about 43%. Only slightly more than 10% of all partnership income was ultimately allocated to domestic taxable corporations. The remainder was split between foreign partners, trusts, Subchapter S-corporations, tax-exempt entities, and unidentified persons. (See 2016 Study, p. 33.)

The study also notes that passthrough participation and passthrough income, in general, are especially concentrated among high-earners. As the report notes: “Relative to households in the bottom half of the income distribution, households in the top-1% of the income distribution are over fifty times as likely to receive positive partnership income. And the average top-1% household earns over six-hundred times the amount of partnership income as the average household in the bottom half.” (See 2016 Study, p. 3.)

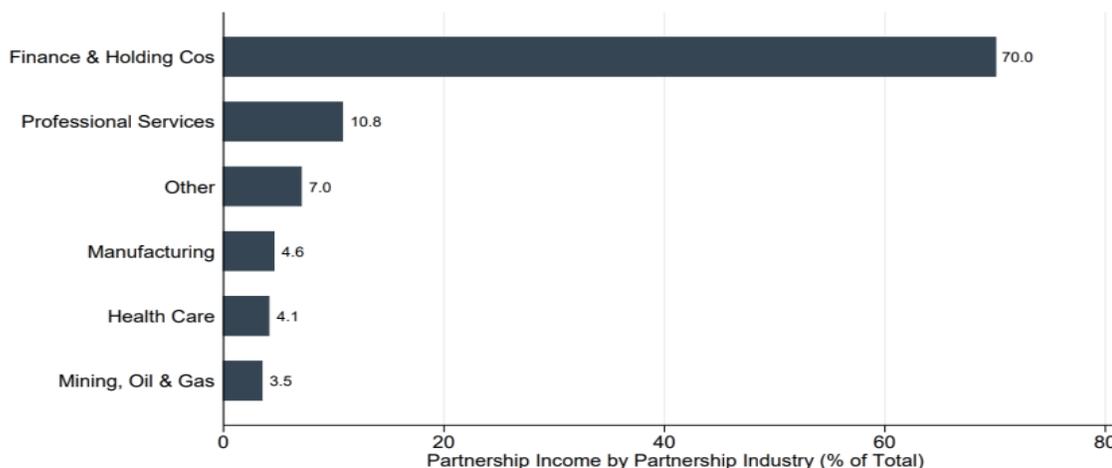
Investment Partnership Industry Segment

The 2016 Study also categorized partnership data into industries by NAICS code as reported by the entity. The Study consolidated certain industry groups for this purpose. The industry group most closely aligned with the investment partnership category, with which this white paper is concerned, was the Finance & Holding Company industry, which also included the real estate investment and insurance industry segments. The Study set out industry information in graphic form. (See 2016 Study, pp. 34 and 39 and the graphs reproduced on the following page).

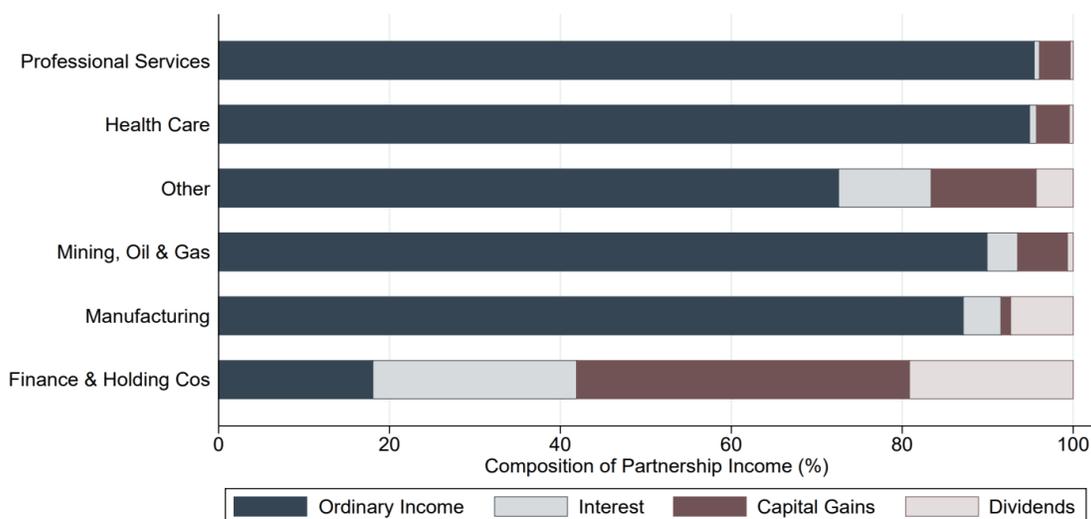
⁵⁰ FLPs are often used as a way to give younger family members an interest in a family business or other assets of the family while potentially reducing gift and estate taxes. See Report: New Data on Family Limited Partnerships Reported on Estate Tax Returns, on the IRS website here: <https://www.irs.gov/pub/irs-soi/11pwcompench2cfam.pdf>.

⁵¹ Supra FN 17.

As these graphs show—the Finance and Holding Company industry group, as categorized by the report, is estimated to account for 70% of all partnership income in the years studied. This income is also more highly diversified between ordinary income, interest, capital gains, and dividends compared to all other industry groups.



Notes: This figure shows the distribution of partnership income across partnership industry. We divide total partnership income received for partnerships in each industry by total partnership income received. These shares exclude income received by other partnerships. Industry groupings and NAICS codes are as follows: Finance & Holding Cos (NAICS 52, 55, and 531); Professional Services (NAICS 54); Manufacturing (NAICS 31, 32, and 33); Health Care (NAICS 62); Mining, Oil, & Gas (NAICS 21).



Other IRS Statistics and Industry Segment Information

The 2016 Study cited above relies on detailed IRS data. The IRS also regularly publishes certain statistical information related to partnerships on the IRS website.⁵² For 2019, this source estimated that the total value of assets held by domestic partnerships was about \$36 trillion. The Finance & Insurance, Real Estate, and Holding Company industry segments held \$20.6 trillion, \$7.8 trillion, and \$1 trillion, respectively, for a total of about \$29.4 trillion, or 82% of all partnership assets.

The total ordinary income reported by partnerships was estimated to be \$292 billion while “portfolio income,” which includes interest, dividends, royalties and capital gains (losses) from investments, but not real property rental income (loss), was estimated to be \$1.2 trillion – approximately 4 times the amount of ordinary income recognized by all partnerships. Of that portfolio income, \$935 billion was estimated to be reported by the Finance & Insurance industry, \$95 billion by the Real Estate Industry, and \$52 billion by the Holding Company industry.

⁵² Available here: <https://www.irs.gov/statistics/soi-tax-stats-partnership-statistics-by-sector-or-industry>.

IRS SOI Bulletin

The IRS also publishes a quarterly SOI, or Statistics of Income, bulletin that analyzes trends in certain tax data. In its Fall 2021 bulletin,⁵³ the IRS reported the following information for the Finance, Insurance, and Real Estate business segments—reproduced here, which also shows that, year-over-year, while the growth in total partnership income was negative 14%, the Finance sector grew 3.3%

Figure D
Partnership Returns: Total Assets, Total Receipts, and Total Net Income (Loss), by Selected Industrial Group, Tax Years 2018 and 2019
 [Money amounts are in thousands of dollars]

Industrial group	Total assets			Total receipts			Total net income (loss)		
	2018	2019	Percentage change	2018	2019	Percentage change	2018	2019	Percentage change
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
All industries	34,348,006,740	36,048,324,019	5.0	8,721,758,922	8,081,449,499	-7.3	884,709,693	760,646,448	-14.0
Finance and insurance	18,954,124,306	20,670,032,817	9.1	2,032,212,084	1,958,954,883	-3.6	426,317,947	440,439,592	3.3
Securities, commodity contracts, and other financial investments and related activities	16,272,592,851	18,004,651,872	10.6	1,722,106,877	1,687,208,123	-2.0	357,509,117	382,072,662	6.9
Securities and commodity contracts and exchanges	680,870,047	704,083,504	3.4	129,834,164	77,716,670	-40.1	3,135,215	9,704,621	209.5
Other financial investment activities	15,591,722,804	17,300,568,368	11.0	1,592,272,713	1,609,491,453	1.1	354,373,902	372,368,042	5.1
Funds, trusts and other financial vehicles	2,319,414,827	2,253,303,980	-2.9	211,120,692	170,197,965	-19.4	53,841,089	42,125,761	-21.8
Other finance and insurance	362,116,628	412,076,965	13.8	98,984,515	101,548,795	2.6	14,967,741	16,241,169	8.5
Real estate and rental and leasing	7,628,478,572	7,864,054,742	3.1	784,722,621	748,808,529	-4.6	97,954,738	41,929,237	-57.2
Real estate	7,380,340,393	7,608,434,999	3.1	703,809,034	669,874,957	-4.8	86,988,620	35,535,894	-59.1
Lessors of residential buildings and dwellings and cooperative housing	2,150,580,855	2,303,869,636	7.1	143,330,835	140,786,321	-1.8	-20,042,681	-31,798,007	58.7
Lessors of nonresidential buildings (except miniwarehouses)	3,297,609,363	3,324,973,028	0.8	250,505,822	213,311,478	-14.8	90,590,576	67,447,682	-25.5
Lessors of miniwarehouses and self-storage units	84,884,720	80,343,263	-5.4	6,450,058	12,691,234	96.8	3,125,745	1,321,313	-57.7
Lessors of other real estate property	264,328,052	228,064,680	-13.7	19,651,661	21,806,553	11.0	2,984,401	2,853,599	-4.4
Other real estate activities	1,582,937,403	1,671,184,391	5.6	283,870,658	281,279,371	-0.9	10,330,579	-4,288,694	-141.5
Rental and leasing services and lessors of nonfinancial intangible assets (except copyrighted works)	248,138,180	255,619,743	3.0	80,913,587	78,933,572	-2.4	10,966,118	6,393,343	-41.7

NOTES: Detail may not add to totals because of rounding. For data on additional industries, see Table 10.
 SOURCE: IRS, Statistics of Income Division, Partnerships, April 2021.

Comparison with Industry Data on Investment Funds

IRS data does not appear to break out income and assets by types of common investment funds—private equity and hedge funds. A 2020 report by McKinsey & Company sheds some additional light on the size of private equity funds. The report notes that private equity funds (excluding hedge funds) have an estimated amount of assets under management equaling \$6.5 trillion worldwide. The report goes on to note that while this represents only about 8% of the total public market capitalization, the balances of these funds are growing almost three times as fast as public markets.⁵⁴ Other sources estimate the total assets managed by hedge funds are in the range of about \$4 trillion worldwide.⁵⁵

Comparison of these types of industry data to IRS data is difficult because the categories used are not often aligned. For example, the 2020 McKinsey report includes data on funds investing primarily in real estate. Nevertheless, it appears that industry data, particularly assets under management, generally comes in lower than IRS industry segment data. In other words, it appears IRS segment data includes a significant number of partnerships other than the typical hedge funds and private equity funds. Again, this simply points out the difficulty in drawing lines to categorize particular types of investment partnerships.

⁵³ Available here: <https://www.irs.gov/pub/irs-pdf/p1136.pdf#page=58>.

⁵⁴ See “A new decade for private markets,” McKinsey Global Private Markets Review 2020, available here: <https://www.mckinsey.com/-/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20private%20markets%20annual%20review/mckinsey-global-private-markets-review-2020-v4.pdf>.

⁵⁵ See, for example, <https://www.statista.com/statistics/271771/assets-of-the-hedge-funds-worldwide/>.

SECTION III: STATE TREATMENT OF INVESTMENT PARTNERSHIPS

A majority of states that tax partnership items on a passthrough basis and source the items based on the partnership's apportionment factors make an exception for certain defined "investment partnerships" or "qualified investment partnerships" (here abbreviated "IPs"). The income generated by these partnerships is sourced, instead, to residence or domicile of the partners. While this separate treatment is common, there are differences, including exactly how such partnerships are defined and whether the exception applies only to individual partners or also to corporations.

This Section III sets out in detail state rules that are applicable and also provides a summary of the different issues which the rules may address, depending on the state.

Section III. A. Summary of Issues

The following is a general summary of issues that may be raised by the special treatment of investment partnership income and which states may have explicitly addressed in their particular rules for that treatment. While there are similarities between state rules, the rules may also vary both in their general approach and in the extent to which they specifically address certain issues. Moreover, depending upon the approach taken by the state, some separate issues listed may not be relevant.

For example, if the state's definition of an "investment partnership" generally excludes partnerships in which corporations hold interests, then there would be no need to exclude corporate partners themselves from the special treatment for investment partnership income. Likewise, if the definition excludes partnerships that have interests in other non-IP partnerships, there is no need to explicitly address which sourcing rules control for income of the non-IP partnership which passes through the IP. In short, the approach taken may require or alleviate the addressing of specific issues

Therefore, rather than attempt to characterize every state's specific treatment of each issue, we have noted examples of particular states that have rules (set out in Section III.B) that may specifically address the particular issue. In some cases, we also note whether there appears to be a clear majority rule among states that have addressed the issue.

Also, in some cases states reference provisions of the Internal Revenue Code, with or without modifications. In particular, IRC § 851, the section governing regulated investment companies, is sometimes referenced by states as its definition for an "investment partnership." Presumably, the state is also adopting any regulatory rules that would also interpret or apply this provision.

In the following Section IV, we discuss in more general terms the different approaches states have taken and the extent to which those approaches reflect similar policies, or may fully address the issues raised.

Issues:

- 1) Apparent basis for the sourcing treatment of IP income:
 - a) Exemption or exclusion
Examples include: Alabama, Arkansas, California, Georgia
 - b) Determination that IP income is nonbusiness income or non-unitary income
Examples include: Connecticut, Illinois
 - c) Determination the IP is not doing business in the state
Examples include: Colorado, Connecticut, North Carolina, Oregon
- 2) Sourcing treatment applies to:
 - a) IP income generally
 - b) Only to qualifying income of the IP
Examples include Alabama, Idaho, Illinois
- 3) Definition of IP includes:
 - a) Assets held test –

- i) Assets, the income from which would be sourced to the partner's residence if recognized by partners directly
For example: Idaho, Kentucky, Utah
- ii) Specified or listed assets:
 - (1) Listing specific types (e.g. stocks and bonds, index securities, futures contracts, options on securities, and other similar financial securities and instruments)
Examples include: Alabama, Illinois
 - (2) Allowable – offices as necessary
Examples include: Alabama, Illinois
- iii) Assets that disqualify the IP
 - (1) Captive REITs
For example: Alabama
 - (2) Interests in non-investment partnerships
Examples include: Alabama, Arkansas
 - (3) Loans that are not debt securities
For example: Alabama
 - (4) Deposits with unregulated institutions
For example: Alabama
- iv) Percentage qualifying assets of total assets
90% is most common
- v) Rules include how value is calculated
For example: Alabama
- b) Income test –
 - i) Definition of income (gross, net, etc.)
For example: Alabama
 - ii) Type or character of income
Most commonly:
 - (1) Interest
 - (2) Dividends
 - (3) Distributions
 - (4) Management fees paid by owners of the entity
 - (5) Gains or losses from the sale or exchange of qualifying investment securities (QIS).
 - iii) Percentage of total income
90% is most common
 - iv) Rules include how income (or gross income) is calculated
For example: Alabama
- c) Ownership test – limiting certain ownership structures
For example: New Jersey
- d) Tied to IRC § 851 (related to RICs) – which uses 50% asset and 90% income tests
Examples include: Connecticut, New York
- e) Owners that may disqualify the entity –
 - i) Corporation
Examples include: Alabama, New Mexico

- ii) Dealers
Examples include: Alabama, Connecticut
- iii) Publicly traded partnerships
Examples include: Alabama, Idaho
- iv) Common trust fund
For example: Alabama
- v) Partnerships electing out under 761
For example: Alabama
- vi) Financial institution
For example: Alabama
- f) Certification required?
For example: Alabama.
- g) Filing required?
For example: Alabama
- h) Are any partners excluded from the special treatment?
 - i) Corporations
For example: Connecticut
 - ii) Managers or non-limited partners
Examples include: Connecticut and Idaho
 - iii) Majority interest holders
For example: Alabama
- i) Special rules with respect to IP income
 - i) Rules do not apply if the IP partner also invests in an underlying business in the state
Examples include: Alabama, Arkansas, California, Illinois
 - ii) Income from the IP is taxable to a nonresident member if assets are acquired with working capital of an in-state trade or business in which the nonresident member owns an interest
Examples include: Alabama, Arkansas, California, Illinois
 - iii) Only income of the type qualifying (on a pass-through basis) is subject to the treatment
For example: Alabama
 - iv) Ability to use IP losses to offset income requires the filing of a state return
For example: Alabama
- j) Anti-abuse authority (including add-back requirements)
Examples include: Alabama, Virginia

Alabama

Rule 810-3-24.2-.02. Qualified Investment Partnerships.

(1) Definitions.

(a) **Qualified Investment Partnership (QIP)**. A partnership or other entity classified as a subchapter K entity, or a business trust as defined in § 40-18-1, Code of Alabama 1975, that for a tax period which begins on or after January 1, 2009, meets the gross income and asset tests for a Qualified Investment Partnership as prescribed by § 40-18-24.2, Code of Alabama 1975; and, **for which an authorized officer, partner, member or manager of the entity has certified for the tax period that the entity meets the gross income and asset tests**. The proper form of the QIP certification and the due date for filing the certification are explained in this regulation.

1. The following restrictions apply concerning entities eligible to be a QIP:

(i) **There is a rebuttable presumption that an entity is disqualified as a QIP as abusive when fifty percent (50%) or more of the ownership interest or voting interest of an entity is owned or controlled, directly or indirectly, by a corporation**, as defined in § 40-18-1, Code of Alabama 1975, or a controlled group of corporations, as defined in 26 U.S.C. §1563, at any time during the tax period. For purposes of this definition, own or control means to own or control directly, indirectly, beneficially, or constructively fifty percent (50%) or more of the voting power or value of an entity. The Department will review written applications or requests to the Commissioner that this presumption not be applied to a particular entity's situation on a case-by-case basis. If the entity establishes that the distributive shares of the income attributed to and owned by the corporate partner are being reported to Alabama for income tax purposes by each of the owners having such interests, the presumption of abuse in this section will have been rebutted.

(ii) **An entity that is classified as a dealer** in qualifying investment security at any time during a tax period, shall not qualify as a QIP for that tax period. An entity is a dealer in qualifying investment securities if it regularly purchases qualifying investment securities from or sells qualifying investment securities to customers in the ordinary course of a trade or business or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in qualifying investment securities with customers in the ordinary course of a trade or business. The definition provided in 26 U.S.C. § 475(c) can also be relied upon to determine if an entity shall be classified as a dealer in qualifying investment securities.

(iii) An entity that is a **publicly-traded partnership** that is taxed as a corporation for Alabama income tax purposes at any time during the tax period cannot be a QIP for that tax period.

(iv) A **common trust fund**, as defined in 26 U.S.C. §584, cannot be a QIP.

(v) An **unincorporated entity that has elected out of the provisions of Subchapter K in accordance with 26 U.S.C. §761**, at any time during a tax period, cannot be a QIP for that tax period.

(vi) Any entity meeting the definition of a **Financial Institution** under Section 40-16-1, Code of Alabama 1975, cannot be a QIP.

(b) **Qualifying Investment Securities (QIS)**. Financial investments as defined by § 40-18-24.2, Code of Alabama 1975, that must be owned by an entity; and must make up a specified percentage of the entity's total assets; in order for the entity to qualify as a QIP, in accordance with § 40-18-24.2, Code of Alabama 1975.

1. The term **"qualifying investment securities" does not include:**

(i) An investment in a captive REIT, as defined by § 40-18-1, Code of Alabama 1975.

(ii) An interest in a partnership unless the partnership is a Qualified Investment Partnership, as defined in § 40-24.2, Code of Alabama 1975

(iii) Loans that are not debt securities.

(iv) Deposits with a bank or other financial institution that is not regulated by the United States government, a state, a governmental agency or by any political subdivision thereof.

(c) Tax Period. Same definition as "taxable year" as defined in § 40-18-1.

(2) QIP Requirements.

(a) All of the following requirements must be met for a tax period in order for an entity to qualify as a QIP for the tax period:

1. Asset Test. No less than 90% of the cost of the total assets owned by the entity consists of qualifying assets: qualifying investment securities (QIS); office facilities; and, tangible personal property reasonably necessary to carry on the activities of the entity as an investment partnership in the State of Alabama.

2. Gross Income Test. No less than 90% of the gross income of the entity consists of qualifying gross income: interest; dividends; distributions; management fees paid by owners of the entity; and gains or losses from the sale or exchange of qualifying investment securities (QIS).

3. Certification. An authorized officer, partner, member, or manager of the entity certifies that for the tax period the entity meets the Asset Test and the Gross Income Test, in the proper form and by the time specified in this regulation. The certification must be filed as part of the annual Alabama partnership income tax return for the entity, on Alabama Schedule QIP-C, by the due date (including extensions) of the Alabama partnership income tax return for the entity. Filing a certification with a composite return for an entity is not a proper filing of the QIP certification.

(i) If the QIP holds an investment in another Subchapter K entity or business trust which is not subject to tax by the State of Alabama, but which qualifies as a QIP under both the Asset Test and the Gross Income Test, the annual certification as to its qualification as a QIP may instead be filed by an authorized officer, partner, member or manager of the QIP, in a manner prescribed by the Department.

(b) Required QIP Filings.

1. A QIP must file an annual Alabama partnership income tax return, properly reporting the required Schedule K-1 information for each resident member and each nonresident member, that held an interest in the QIP, at any time during the tax period.

2. A QIP must file an annual composite income tax return, as required by § 40-18-24.2, Code of Alabama 1975, if the QIP is required to make a composite payment for one or more non-resident members.

(c) Application of the Asset Test.

1. For purposes of applying the Asset Test, the cost of an asset will generally be the entity's basis, computed in accordance with Alabama income tax law (See §§ 40-18-24 and 40-18-6, Code of Alabama 1975). For office facilities, other tangible personal property, any assets subject to amortization and any assets subject to depletion; the cost to be used will be the entity's basis before any reductions for depreciation, amortization or depletion. The cost of qualifying investment securities shall include any accrued interest or discount and shall be reduced by any premium amortization, that has been recognized in the computation of Alabama taxable income of the

entity and that is included on the entity's balance sheet as of the date the asset's cost was determined.

2. The Asset Test is applied for each tax period, and is computed using the ratio of the entity's cost of its qualifying assets to the entity's cost of its total assets, expressed as a percentage; as of the beginning of the tax period and as of the end of the tax period. The average of the percentages is then computed. The average is referred to as the Average Qualifying Asset Percentage for the Tax Period.

(d) Application of the Gross Income Test.

1. **The Gross Income Test** is applied for each tax period, and is computed using the ratio of the entity's qualifying gross income to its total gross income, expressed as a percentage. The ratio is referred to as the Qualifying Gross Income Percentage.

2. Calculations for the Gross Income Test are to be based on information from the Alabama partnership income tax return filed by the entity for the tax period.

3. Gross income means income minus costs of sales or basis in an asset sold or traded, but without reduction for any other expenses or deductions.

4. Gross income does not include any item of income that is excluded in computing the Alabama taxable income of the entity.

5. The Gross Income Test is calculated using the method of accounting used for Alabama income tax purposes for the tax period.

6. Gross income derived from an investment in a qualifying investment partnership, subchapter S corporation, trust or estate shall be characterized as if the entity received the income directly.

7. Gross income derived from a qualifying investment partnership, subchapter S corporation, trust or estate for purposes of the Gross Income Test shall be reduced by related expenses and computed in accordance with Alabama income tax law.

Rule 810-3-24.2-.01. Composite Returns of Passthrough Entities.

...

(n) State Explanations An annual composite return is due for a Qualified Investment Partnership (QIP), only if the QIP is required to remit a composite payment for one or more nonresident members.

...

Rule 810-3-24.2-.03. Other Qualified Investment Partnership Matters.

(1) Every nonresident member of a Qualified Investment Partnership (QIP) that has Alabama source income must file an Alabama income tax return and report the Alabama source income even if the income earned in Alabama is included on a composite return filed by the QIP, unless the member is a nonresident individual who has no other Alabama source income. **For a nonresident individual to claim the benefit of any net operating losses generated by a QIP, the nonresident individual must establish those losses by filing an Alabama individual income tax return.**

(2) The QIP Alabama income tax reporting requirements do not change the Alabama income tax return filing requirements for business entities.

(3) **In accordance with § 40-18-24.3 , Code of Alabama 1975, a nonresident member of a QIP will be exempt from Alabama income tax on its distributive share of QIP income unless the nonresident member actively participates in the day-to-day management of the QIP or the QIP invests in the qualifying investment securities of an entity that is majority owned by the nonresident member.**

(a) The term "majority owned" is defined in § 40-18-24.3, Code of Alabama 1975, and includes the attribution rules of 26 U.S.C. §318.

(b) Income from a QIP is taxable to a nonresident member of the QIP if the income is from investment activity that is interrelated with an Alabama trade or business in which the nonresident member owns an interest even if the primary activities of the trade or business are separate and distinct from the acts of acquiring, managing, or disposing of qualified investment securities.

(c) Income from a QIP is taxable to a nonresident member of the QIP if any part of the qualifying investment securities of the QIP are acquired with the working capital of an Alabama trade or business in which the nonresident member owns an interest.

(d) A financial institution, as defined in § 40-16-1, Code of Alabama 1975, if a nonresident member of a QIP, is taxed on its distributive share of income from the QIP if it participates in the management of the investment activities of the QIP; if it is engaged in a unitary business with another taxpayer that participates in managing the investment activities of the QIP; or, if the financial institution has income from Alabama sources.

(e) A corporation, as defined in § 40-18-1, Code of Alabama 1975, if a nonresident member of a QIP, is taxed on its distributive share of income from a QIP if it participates in the management of the investment activities of the QIP; if it is engaged in a unitary business with another taxpayer that participates in managing the investment activities of the QIP; or, if the corporation has income from Alabama sources.

(4) The allocation and apportionment requirements set out in the Multistate Tax Compact, codified in Chapter 27, Title 40, Code of Alabama 1975, and all rules pertaining to such laws are applicable to Alabama income tax returns and composite returns required to be filed by passthrough entities, including those required to be filed by Qualified Investment Partnerships.

(5) Business Trust. The term "business trust" is defined in § 40-18-1, Code of Alabama 1975.

(a) For federal income tax purposes, a business trust is classified as a business entity, not as a business trust. A business trust may only be classified as a disregarded entity, a partnership, or a corporation.

1. A business trust that has made a federal election to be treated as a corporation, at any time during the tax period, cannot qualify as a QIP for the tax period.

2. A business trust that is treated as a disregarded entity for federal income tax purposes, at any time during the tax period, cannot qualify as a QIP for the tax period.

3. A business trust that is treated as a partnership for federal income tax purposes can qualify as a QIP, if the entity satisfies the requirements of Section 40-18-24.2, Code of Alabama 1975, and the rules promulgated thereunder.

(6) In order to correct the effect and result of a tax-avoidance or a tax abusive arrangement, or series of transactions, the Commissioner of Revenue shall have the authority to distribute, apportion, or allocate the gross income of any passthrough entity, QIP, or passthrough entity member in order to clearly, fairly, and equitably reflect the income of any entity, passthrough entity, QIP, or QIP member, whose income may have been significantly distorted by the application of the tax-avoidance or tax abusive arrangement, or series of transactions. The Commissioner of Revenue may recast QIP transactions if it is determined the transactions do not have a substantial business purpose or it is determined that the form of the transactions yield results that have the substance of tax-avoidance or tax abuse.

(7) The Commissioner of Revenue may revoke an entity's QIP status for one or more tax periods if it is determined that the entity did not meet the QIP requirements for that or those tax periods.

Arkansas

§ 26-51-202 -- Nonresidents.

(a) A tax is imposed and shall be assessed, levied, collected, and paid annually at the rates specified in § 26-51-201 upon and with respect to the entire net income as defined in this chapter, except as provided in this section, from all property owned and from every business, trade, or occupation carried on in this state by individuals, corporations, partnerships, trusts, or estates not residents of the State of Arkansas.

(b)

(1) Each nonresident as defined in § 26-51-102 shall file income tax returns with the State of Arkansas and pay the tax without distinction, or incident to the laws of the nonresident's resident state.

(2) It is the specific intention of the General Assembly that the tax shall be collected from property owned and from the conduct of every business, trade, or occupation, whether or not the individuals, corporations, partnerships, trusts, or estates are qualified to do business in the State of Arkansas and whether or not such business, trade, or occupation shall be conducted in interstate commerce.

(c)

(1) However, the payment of the tax shall be based upon net income properly allocated as net income arising from the ownership of property and the conduct of a business, trade, or occupation in the State of Arkansas.

(2) CAUTION: Subsection (c)(2) is eff. for tax years beginning on or after 1-1-2021.

A nonresident individual who is paid a salary, lump sum payment, or any other form of payment that encompasses work performed both inside and outside of Arkansas shall pay Arkansas income tax only on the portion of the individual's income that reasonably can be allocated to work performed in Arkansas.

(3) CAUTION: Subsection (c)(3) is eff. for tax years beginning on or after 1-1-2021.

A nonresident individual performs work in Arkansas when that individual is physically located in Arkansas when performing the work.

(d) Additionally, no income tax shall be due the State of Arkansas from a nonresident beneficiary on income received from a trust or estate being administered by a resident trustee or personal representative except on income derived by the trust or estate from:

(1) Lands situated in this state, including gains from any sale of the lands situated in this state;

(2) Any interest in land situated in this state, including, without limitation, chattels real, including gains from any sale of an interest in land situated in this state;

(3) Tangible personal property located in Arkansas, including gains from any sale of the tangible personal property located in Arkansas; and

(4) Unincorporated businesses domiciled in Arkansas.

(e)

(1) No income tax shall be due the State of Arkansas from a nonresident partner with respect to that partner's distributive share of dividends, interest, or gains and losses from qualifying investment securities owned by an investment partnership, whether or not the partnership has a usual place of business located in this state.

(2) As used in this subsection:

(A) "Investment partnership" means a partnership that meets both of the following requirements:

(i) No less than ninety percent (90%) of the value of the partnership's total assets consists of qualifying investment securities and office space and equipment reasonably necessary to carry on its activities as an investment partnership; and

(ii) No less than ninety percent (90%) of its gross income consists of interest, dividends, and gains from the sale or exchange of qualifying investment securities; and

(B) "Qualifying investment securities" includes all of the following:

(i) Common stock, including preferred or debt securities convertible into common stock, and preferred stock;

(ii) Bonds, debentures, and other debt securities;

(iii) Deposits and any other obligations of banks and other financial institutions;

(iv) Stock and bond index securities, futures contracts, options on securities, and other similar financial securities and instruments; and

(v) Other similar or related financial or investment contracts, instruments or securities. Qualifying investment securities shall not include an interest in a partnership unless that partnership is itself an investment partnership.

(3)(A) The provisions of subdivision (e)(1) of this section shall not apply to income derived from investment activity that is interrelated with any trade or business activity of the nonresident or an entity in which the nonresident owns an interest in this state, whose primary activities are separate and distinct from the acts of acquiring, managing, or disposing of qualified investment securities, or if those securities were acquired with working capital of a trade or business activity conducted in this state in which the nonresident owns an interest.

(B) Likewise, the provisions of subdivision (e)(1) of this section shall not apply to corporate partners of an investment partnership except as provided by regulations adopted by the Director of the Department of Finance and Administration.

California

§ 17955 -- Amounts excluded from gross income in specified circumstances; "Investment partnership"; "Qualifying investment securities".

(a) For purposes of computing "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of Section 17041, notwithstanding Sections 17951, 17952, and 17953, gross income of a nonresident (as defined in Section 17015) from sources within this state shall not include dividends, interest, or gains and losses from qualifying investment securities if any of the following apply:

(1) In the case of an individual, with respect to the qualifying investment securities, the taxpayer's only contact with this state is through a broker, dealer, or investment adviser located in this state.

(2) In the case of a partner's distributive share of income from qualifying investment securities, the partnership qualifies as an investment partnership, whether or not the partnership has a usual place of business located in this state.

(3) In the case of a beneficiary of a qualifying estate or trust, the taxpayer's only contact with this state is through an investment account managed by a corporate fiduciary located in this state.

(4) In the case of a unit holder in a regulated investment company (as defined in Section 851 of the Internal Revenue Code), to the extent of the dividends distributed by the regulated investment company, whether or not the regulated investment company has a principal place of business in this state.

(b) This section shall not apply to income derived from investment activity that is interrelated with any trade or business activity of the nonresident or an entity in which the nonresident owns an interest in this state, whose primary activities are separate and distinct from the acts of acquiring, managing, or disposing of qualified investment securities, or if those securities were acquired with working capital of a trade or business activity conducted in this state in which the nonresident owns an interest.

(c) For purposes of this section:

(1) "Investment partnership" means a partnership that meets both of the following requirements:

(A) No less than 90 percent of the partnership's cost of its total assets consist of qualifying investment securities, deposits at banks or other financial institutions, and office space and equipment reasonably necessary to carry on its activities as an investment partnership.

(B) No less than 90 percent of its gross income consists of interest, dividends, and gains from the sale or exchange of qualifying investment securities.

(2) "Qualifying estate or trust" means an estate or trust that meets both of the following requirements:

(A) No less than 90 percent of the estate's or trust's cost of its total assets consist of qualifying investment securities, deposits at banks or other financial institutions, and office space and equipment reasonably necessary to carry on its investment activities.

(B) No less than 90 percent of its gross income consists of interest, dividends, and gains from the sale or exchange of qualifying investment securities.

(3)(A) "Qualifying investment securities" include all of the following:

(i) Common stock, including preferred or debt securities convertible into common stock, and preferred stock.

(ii) Bonds, debentures, and other debt securities.

(iii) Foreign and domestic currency deposits or equivalents and securities convertible into foreign securities.

(iv) Mortgage- or asset-backed securities secured by federal, state, or local governmental agencies.

(v) Repurchase agreements and loan participations.

(vi) Foreign currency exchange contracts and forward and futures contracts on foreign currencies.

(vii) Stock and bond index securities and futures contracts, and other similar financial securities and futures contracts on those securities.

(viii) Options for the purchase or sale of any of the securities, currencies, contracts, or financial instruments described in clauses (i) to (vii), inclusive.

(ix) Regulated futures contracts.

(B) "Qualifying investment securities" does not include an interest in a partnership unless that partnership is itself an investment partnership.

Colorado

39 Colo. Code Regs. § 22-109(3)(c)(vii) Investment Partnerships. A partnership whose sole activity is to buy and sell securities for its own account is not carrying on a Business in Colorado. Therefore, a Nonresident individual partner of such a partnership is not subject to Colorado income tax on their distributive share of such partnership income. § 39-22-109(2)(a)(V), C.R.S. A partnership that engages in other activities in Colorado that are neither the described activities here nor entirely ancillary to such activities is carrying on Business in Colorado.

Connecticut

Conn. Gen. Stat. § 12-214(a)(3)(C) A company that is not otherwise carrying on or doing business in this state, either directly or by virtue of being a partner in a partnership described in subparagraph (A) or (B) of this subdivision is not carrying on or doing business in this state solely by virtue of being a limited partner of one or more investment partnerships.

Conn. Gen. Stat. § 12-213(a)(26) "Investment partnership" means a limited partnership that meets the gross income requirement of Section 851(b)(2) of the Internal Revenue Code, except that income and gains from commodities that are not described in Section 1221(1) of the Internal Revenue Code or from futures, forwards and options with respect to such commodities shall be included in income which qualifies to meet such gross income requirement, provided such commodities are of a kind customarily dealt with in an organized commodity exchange and the transaction is of a kind customarily consummated at such place, as required by Section 864(b)(2)(B)(iii) of the Internal Revenue Code. To the extent that such a partnership has income and gains from commodities that are not described in Section 1221(1) of the Internal Revenue Code or from futures, forwards, and options with respect to such commodities, such income and gains must be derived by a partnership which is not a dealer in commodities and is trading for its own account as described in Section 864(b)(2)(B)(ii) of the Internal Revenue Code. The term "investment partnership" does not include a dealer, within the meaning of Section 1236 of the Internal Revenue Code, in stocks or securities;

Conn. Gen. Stat. § 12-218e(a)(4)(B) The distributive share of income received by a limited partner from an investment partnership shall not be considered to be derived from a unitary business unless the general partner of such investment partnership and such limited partner have common ownership. To the extent that the limited partner is otherwise carrying on or doing business in Connecticut, it shall apportion its distributive share of income from an investment partnership in accordance with subdivision (2) of subsection (g) of section 12-218. If the limited partner is not otherwise carrying on or doing business in Connecticut, its distributive share of income from an investment partnership is not subject to tax under this chapter.

Conn. Gen. Stat. § 12-219a(b)

(1) Any company that is (A) a limited partner in a partnership, other than an investment partnership, that does business, owns or leases property or maintains an office within this state and (B) not otherwise carrying on or doing business in this state shall apportion the average value of its partnership interest within and without this state under the provisions of subsection (a) of this section, except that the numerator and the denominator of its apportionment fraction shall be its proportionate part of the partnership's apportionment factors. For purposes of this section, the partnership shall compute its apportionment fraction and the numerator and the denominator of its apportionment factors as if it were a company taxable both within and without this state. However, if the commissioner determines that the company and the partnership are, in substance, parts of a unitary business engaged in a single business enterprise, or, if the company is a member of a combined group that files a combined unitary tax return, the company shall be taxed in accordance with the provisions of subdivision (3) of this subsection and not in accordance with the provisions of this subdivision.

(2) Any company that is (A) a limited partner (i) in an investment partnership or (ii) in a limited partnership, other than an investment partnership, that does business, owns or leases property or maintains an office within this state and (B) otherwise carrying on or doing business in this state shall apportion its additional tax base, including the average value of its partnership interest, within and without the state

under the provisions of subsection (a) of this section, except that the numerator and the denominator of its apportionment factors shall include its proportionate part of the numerator and the denominator of the partnership's apportionment factors. For purposes of this section, the partnership shall compute its apportionment fraction and the numerator and the denominator of its apportionment factors, as if it were a company taxable both within and without this state.

Conn. Gen. Stat. § 12-711(f)

Any nonresident, other than a dealer holding property primarily for sale to customers in the ordinary course of his trade or business, shall not be deemed to carry on a trade, business, profession or occupation in this state solely by reason of the purchase or sale of intangible property or the purchase, sale or writing of stock option contracts, or both, for his own account.

Georgia

O.C.G.A. §48-7-24(c) Notwithstanding any other provision of this chapter to the contrary, the distributive share of a nonresident member of a resident limited partnership or other similar nontaxable entity which derives income exclusively from buying, selling, dealing in, and holding securities on its own behalf and not as a broker shall not constitute taxable income under this chapter. For purposes of this subsection, a resident limited partnership or similar nontaxable entity shall not include a family limited partnership or similar nontaxable entity the majority interest of which is owned by one or more natural or naturalized citizens related to each other within the fourth degree of reckoning according to the laws of descent and distribution. This subsection shall not apply to a person that participates in the management of the resident limited partnership or other similar nontaxable entity or that is engaged in a unitary business with another person that participates in the management of the resident limited partnership or other similar nontaxable entity.

Idaho

Idaho Code § 63-3026A(3)(c) Nonresident individuals shall not be taxable on investment income from a qualified investment partnership. For purposes of this paragraph, a "qualified investment partnership" means a partnership, as defined in section 63-3006B, Idaho Code, that derives at least ninety percent (90%) of its gross income from investments that produce income that would not be taxable to a nonresident individual if the investment were held by that individual.

Idaho Regs. § 35.01.01.275.

01 In General.

a. For taxable years beginning on or after January 1, 2007, the Idaho taxable income of a nonresident individual does not include the distributive share of investment income of a qualified investment partnership. The distributive share of noninvestment income of a qualified investment partnership derived from or related to sources within Idaho is included in Idaho taxable income. See Rule 250 of these rules for information on when pass-through income from a partnership is deemed to have been received. (7-1-21)T

b. The exemption from tax on investment income from a qualified investment partnership does not apply to gains or losses derived from the sale of a nonresident individual's interest in a qualified investment partnership. The source of these gains and losses is governed by Section 63-3026A(3)(a)(vii), Idaho Code, and Rule 266 of these rules. The source of investment income that is not from a qualified investment partnership is determined as provided in Rule 263 of these rules. (7-1-21)T

02. Qualified Investment Partnership. An entity is a qualified investment partnership only if it meets both of the following criteria: (7-1-21)T

a. The entity is classified as a partnership for federal income tax purposes, but is not a publicly traded partnership taxed as a corporation under Section 63-3006, Idaho Code. (7-1-21)T

b. The gross income from investments of the entity is derived at least ninety percent (90%) from investments that when held by a nonresident individual directly, would not produce income subject to the Idaho income tax. See Rules 263 and 266 of these rules. (7-1-21)T

03. Investment Income. For purposes of this exclusion, an item of partnership income is investment income only if it would not be Idaho taxable income of a nonresident individual if the individual held the investment directly. (7-1-21)T

04. Examples. (7-1-21)T

a. A is a nonresident individual member of ABC, a partnership operating solely within Idaho. The taxable income of ABC for the taxable year consists of ninety thousand dollars (\$90,000) of dividend income and ten thousand dollars (\$10,000) of capital gains from stock trading through a brokerage account. If A held the stock directly, Section 63-3026A(3)(a)(iii), Idaho Code, provides that the dividends and capital gains would not be included in Idaho taxable income. Since at least ninety percent (90%) of ABC's income is from investments that would not be taxable to a nonresident individual if held directly by that individual, ABC is a qualified investment partnership and none of A's distributive share of the income is included in Idaho taxable income even though ABC is an Idaho partnership. (7-1-21)T

b. Assume the same facts as in Paragraph 275.04.a. of this rule, except that the ten thousand dollars (\$10,000) of capital gains is from the sale of Idaho real property. Since at least ninety percent (90%) of ABC's income is from investments that would not be taxable to a nonresident individual if held directly by that individual, ABC is a qualified investment partnership. A's distributive share of ABC's dividend income is excluded from A's Idaho taxable income, but A's distributive share of ABC's gain from the sale of Idaho real property is included in Idaho taxable income because Section 63-3026A(3), Idaho Code, provides that such income would be taxable to A if A had owned the property directly. (7-1-21)T

c. A is a nonresident individual member of ABC, a partnership operating solely within Idaho. The taxable income of ABC for the taxable year consists of eighty thousand dollars (\$80,000) of dividend income and twenty thousand dollars (\$20,000) of capital gains from the sale of Idaho real property. ABC is not a qualified investment partnership because less than ninety percent (90%) of ABC's income is from investments that would not be taxable to a nonresident individual if held directly by that individual. A's distributive share of ABC's dividend income and capital gain income is included in Idaho taxable income as provided in Rule 263 of these rules. (7-1-21)T

d. A is a nonresident individual partner in ABC, a partnership with a fifty percent (50%) Idaho apportionment factor. The gross income of ABC consists of ninety thousand dollars (\$90,000) of dividend income, five thousand dollars (\$5,000) of capital gain from the sale of non-Idaho real property used in the trade or business, and five thousand dollars (\$5,000) of gross business income. Since at least ninety percent (90%) of ABC's gross income is from investments that would not be taxable to a nonresident individual if held directly by that individual, ABC is a qualified investment partnership. A's distributive share of ABC's dividend income is excluded from A's Idaho taxable income, but fifty percent (50%) of A's distributive share of ABC's gain from the sale of non-Idaho real property (which is business income under the facts of this example) and fifty percent (50%) of A's distributive share of ABC's other business income is included in Idaho taxable income, based on the Idaho apportionment factor of the partnership as provided in Section 63-3026A(3)(a)(i) and Rule 263 of these rules. (7-1-21)T

Illinois

35 ILCS 5/305(c-5)

Taxable income of an investment partnership, as defined in Section 1501(a)(11.5) of this Act, that is distributable to a nonresident partner shall be treated as nonbusiness income and shall be allocated to the partner's state of residence (in the case of an individual) or commercial domicile (in the case of any other person). However, any income distributable to a nonresident partner shall be treated as business income and apportioned as if such income had been received directly by the partner if the partner has made an

election under Section 1501(a)(1) of this Act to treat all income as business income or if such income is from investment activity:

(1) that is directly or integrally related to any other business activity conducted in this State by the nonresident partner (or any member of that partner's unitary business group);

(2) that serves an operational function to any other business activity of the nonresident partner (or any member of that partner's unitary business group) in this State; or

(3) where assets of the investment partnership were acquired with working capital from a trade or business activity conducted in this State in which the nonresident partner (or any member of that partner's unitary business group) owns an interest.

35 ILCS 5/1501(11.5) Investment partnership.

(A) The term "investment partnership" means any entity that is treated as a partnership for federal income tax purposes that meets the following requirements:

(i) no less than 90% of the partnership's cost of its total assets consists of qualifying investment securities, deposits at banks or other financial institutions, and office space and equipment reasonably necessary to carry on its activities as an investment partnership;

(ii) no less than 90% of its gross income consists of interest, dividends, and gains from the sale or exchange of qualifying investment securities; and

(iii) the partnership is not a dealer in qualifying investment securities.

(B) For purposes of this paragraph (11.5), the term "qualifying investment securities" includes all of the following:

(i) common stock, including preferred or debt securities convertible into common stock, and preferred stock;

(ii) bonds, debentures, and other debt securities;

(iii) foreign and domestic currency deposits secured by federal, state, or local governmental agencies;

(iv) mortgage or asset-backed securities secured by federal, state, or local governmental agencies;

(v) repurchase agreements and loan participations;

(vi) foreign currency exchange contracts and forward and futures contracts on foreign currencies;

(vii) stock and bond index securities and futures contracts and other similar financial securities and futures contracts on those securities;

(viii) options for the purchase or sale of any of the securities, currencies, contracts, or financial instruments described in items (i) to (vii), inclusive;

(ix) regulated futures contracts;

(x) commodities (not described in Section 1221(a)(1) of the Internal Revenue Code) or futures, forwards, and options with respect to such commodities, provided, however, that any item of a physical commodity to which title is actually acquired in the partnership's capacity as a dealer in such commodity shall not be a qualifying investment security;

(xi) derivatives; and

(xii) a partnership interest in another partnership that is an investment partnership.

Investment Partnerships. For taxable years ending on or after July 30, 2004 (the effective date of Public Act 93-840), in the case of an investment partnership, as defined in Section 100.9730 of this Part:

1) Except as provided in subsection (d)(2), taxable income that is distributable to a nonresident partner shall be treated as nonbusiness income and shall be allocated to the partner's state of residence (in the case of an individual) or commercial domicile (in the case of any other person). (IITA Section 305(c-5)) IITA Section 203(e)(3) shall not require recapture of business expenses if the income from an investment partnership was treated as business income in years prior to July 30, 2004 (the effective date of Public Act 93-840) and is treated as nonbusiness income under this subsection (d).

2) Any income distributable to a nonresident partner shall be treated as business income and apportioned as if such income had been received directly by the partner if the partner has made an election under Section 1501(a)(1) of the IITA to treat all income as business income or if such income is from investment activity:

A) that is directly or integrally related to any other business activity conducted in this State by the nonresident partner (or any member of that partner's unitary business group) (IITA Section 305(c-5)(1));

B) that serves an operational function to any other business activity of the nonresident partner (or any member of that partner's unitary business group) in this State (IITA Section 305(c-5)(2)); or

C) where assets of the investment partnership were acquired with working capital from a trade or business activity conducted in this State in which the nonresident partner (or any member of that partner's unitary business group) owns an interest (IITA Section 305(c-5)(3)).

3) Income treated as business income received directly by a partner under subsection (d)(2) shall be apportioned using the apportionment factors of the partner, without regard to any factors of the partnership.

Kentucky

Ky. Rev. Stat. Ann. § 141.206(14)

(a) Nonresident individuals shall not be taxable on investment income distributed by a qualified investment partnership. For purposes of this subsection, a "qualified investment partnership" means a pass-through entity that, during the taxable year, holds only investments that produce income that would not be taxable to a nonresident individual if held or owned individually.

(b) A qualified investment partnership shall be subject to all other provisions relating to a pass-through entity under this section and shall not be subject to the tax imposed under KRS 141.040 or 141.0401.

Massachusetts

830 CMR 62B.2.2

(2) Definitions .

...

Distributive Share , income, gain, loss, deduction, or credit from a pass-through entity for a taxable year allocated to a member taxable under M.G.L. c. 62 or c. 63.

Investment Partnership , a partnership, including a limited liability company with any member treated as a partner under Massachusetts tax law, that meets the following three criteria:

- (a) **substantially all** of the partnership's assets consist of investment securities, deposits at banks or other financial institutions, or office equipment and office space reasonably necessary to carry on the activities of an investment partnership;
- (b) substantially all of the partnership's income is from interest, dividends and capital gains; and
- (c) the partnership is not engaged in a trade or business in Massachusetts.

Massachusetts-source Income , Massachusetts gross income derived from or effectively connected with:

- (a) any trade or business, including any employment, carried on by a pass-through entity in Massachusetts, whether or not the entity is actively engaged in a trade or business or employment in Massachusetts in the year in which the income is received;
- (b) the participation in any lottery or wagering transaction in Massachusetts; or
- (c) the ownership of any interest in real or tangible personal property located in Massachusetts.

Pass-through entities with income from sources both within Massachusetts and elsewhere must allocate and apportion the income according to 830 CMR 62.5A.1 (6) to determine the amount of Massachusetts-source income.

Member , a member of a pass-through entity, including a shareholder of an S corporation; a partner in a partnership, including a limited partner in a limited partnership and a partner in a limited liability partnership; a member of a limited liability company treated as a partner under Massachusetts tax law; and a beneficiary of an estate.

Nonresident, any natural person, estate, or trust that is not a resident or domiciliary of Massachusetts; any pass-through entity without a usual place of business in Massachusetts; or any corporation that is not required to file or does not file a tax return in Massachusetts with regard to distributive share derived from a pass-through entity that is subject to the provisions of 830 CMR 62B.2.2.

Pass-through Entity , an entity whose income, loss, deductions and credits flow through to members for Massachusetts tax purposes, including a general partnership, limited partnership, limited liability partnership, or limited liability company with a member treated as a partner under Massachusetts tax law, an S corporation, an estate not taxed at the entity level, and a trust not taxed at the entity level, including a grantor-type trust.

Publicly Traded Partnership , an entity defined as a publicly traded partnership by § 7704(b) of the Internal Revenue Code that is treated as a partnership for the taxable year under the Internal Revenue Code.

Qualified Securities Partnership , a limited partnership that is engaged exclusively in buying, selling, dealing in or holding securities on its own behalf, and not as a broker, as described in M.G.L. c. 62, § 17(b) or 830 CMR 63.39.1 (8)(b) .

Tiered Structure , a pass-through entity that has a pass-through entity as a member. As between two entities, the pass-through entity that is a member is the upper-tier entity, and the entity of which it is a member is the lower-tier entity. A tiered pass-through entity arrangement may have two or more tiers; in such cases, a single entity can be both a lower-tier and an upper-tier entity.

(3) Pass-through Entities Required to Withhold; Members Subject to Withholding .

- (a) General Rule . A pass-through entity that maintains an office or engages in business in Massachusetts must deduct and withhold Massachusetts tax from the member's pro-rata share of the pass-through entity's Massachusetts-source income, unless:

1. the pass-through entity is exempt from this requirement under 830 CMR 62B.2.2(3)(b); or
2. the member is exempt from this requirement under 830 CMR 62B.2.2(3)(c).

(b) **Exempt Pass-through Entities . The following pass-through entities are not required to participate in pass-through entity withholding:**

1. **An Investment Partnership or a partnership that only invests in Investment Partnerships and has no Massachusetts-source income from other sources;**
2. A trust or estate that is already required to withhold on nonresident members, if it has any, under M.G.L. c. 62, § 10(g);
3. An upper-tier pass-through entity in a tiered structure that can demonstrate that a lower-tier pass-through entity has previously withheld and made estimated payments of all of the Massachusetts tax on Massachusetts-source income derived by the upper-tier pass-through entity that would otherwise be subject to withholding by the upper-tier entity. (See tiered structures at 830 CMR 62B.2.2(5).)
4. A Publicly Traded Partnership; and
5. An entity that is prohibited under federal or state law from withholding tax from distributions to members as otherwise required under 830 CMR 62B.2.2, such as certain for-profit entities that provide low-income housing which are funded by or through Mass-Housing or the United States Department of Housing and Urban Development; the exemption applies only for years in which distributions are prohibited under federal or state law. Contractual restrictions on distributions, such as loan covenants or organizational documents, do not qualify an entity for this exemption.

Maryland

Maryland Administrative Release No. 6

II. Exemptions

B. Partnerships

Partnerships whose activities and assets are limited to investment in stocks, bonds, futures, options or debt obligations other than debt instruments directly secured by real or tangible personal property are not subject to the nonresident member tax merely because the investment decisions, trading orders, research and the like are conducted by a general partner from a Maryland location. Partnerships, however, such as brokerage firms which deal with the general public, are not exempt if the business is conducted within Maryland.

New Jersey

N.J. Rev. Stat. § 54A:5-8

a. Income from sources within this State for a nonresident individual, estate or trust means the income from the categories of gross income enumerated and classified under chapter 5 of this act to the extent that it is earned, received or acquired from sources within this State:

- (1) By reason of ownership or disposition of any interest in real or tangible personal property in this State; or
- (2) In connection with a trade, profession, occupation carried on in this State or for the rendition of personal services performed in this State; or

(3) As a distributive share of the income of an unincorporated business, profession, enterprise, undertaking or other activity as the result of work done, services rendered or other business activities conducted in this State except as allocated to another state pursuant to regulations promulgated by the director under this act; or

(4) From intangible personal property employed in a trade, profession, occupation or business carried on in this State; or

c. For purposes of paragraphs (2) through (4) of subsection a. of this section, a nonresident taxpayer shall not be deemed to be carrying on a trade, profession, occupation, business, enterprise, undertaking or other activity in this State, or to be rendering personal services in this State, solely as a result of the purchase, holding and sale of intangible personal property by the trade, profession, occupation, business, enterprise or undertaking, to the extent that (1) the activities related to the intangible personal property are for the account of the trade, profession, occupation, business, enterprise, or undertaking and (2) the trade, profession, occupation, business, enterprise, or undertaking does not hold the intangible personal property for sale to customers. For the purposes of this subsection: "intangible personal property" includes, but is not limited to, "commodities", as defined in paragraph (2) of subsection (e), and "securities," as defined in paragraph (2) of subsection (c), of section 475 of the federal Internal Revenue Code of 1986, 26 U.S.C. s.475; and "purchase, holding and sale of intangible personal property" includes activities incidental thereto giving rise to income, including commitment fees, breakup fees, income from securities lending, and any other incidental activities as prescribed or authorized by the director. The director shall adopt such regulations as the director deems necessary to accomplish the purposes of this section.

N.J. Rev. Stat. § 54:10A-4(r) "Qualified investment partnership" means a partnership under this act that has more than 10 members or partners with no member or partner owning more than a 50% interest in the entity and that derives at least 90% of its gross income from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stocks or securities or foreign currencies or commodities or other similar income (including but not limited to gains from swaps, options, futures or forward contracts) derived with respect to its business of investing or trading in those stocks, securities, currencies or commodities, but "investment partnership" shall not include a "dealer in securities" within the meaning of section 1236 of the federal Internal Revenue Code of 1986, 26 U.S.C. s.1236.

N.J. Admin. Code tit. 18, § 7-1.21

(a) "Qualified investment partnership" means a partnership under this Act that has more than 10 members or partners with no member or partner owning more than a 50 percent interest in the partnership and that derives at least 90 percent of its gross income from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stocks or securities or foreign currencies or commodities or other similar income (including, but not limited to, gains from swaps, options, futures or forward contracts) derived with respect to its business of investing or trading in those stocks, securities, currencies, or commodities, but "investment partnership" shall not include a "dealer in securities" within the meaning of I.R.C. § 1236. 26 U.S.C. § 1236 .

1. If a partnership would otherwise qualify as a "qualified investment partnership," except that it has 10 or fewer partners, such partnership is deemed a "qualified investment partnership," if:

i. It is managed by an independent third party for a fee;

ii. There is no direct or indirect relationship between the manager and any of the partners; and

iii. There is no direct or indirect affiliation between or among the partners.

New Mexico

N.M. Code R. § 3.3.11.14

A. Income of an individual, other than a dealer holding securities for sale to customers in the ordinary course of the dealer's trade or business, from the purchase or sale of securities for the individual's own account or from the writing of securities option contracts for the individual's own account is deemed to be income other than income from engaging in a trade or business. The income is allocable to the individual's state of residence.

B. Income of an investment entity from the purchase or sale of securities for the entity's own account or from the writing of securities option contracts in the entity's own account is deemed to be income other than income from engaging in a trade or business. The income attributable to each of the entity's owners is allocable to that owner's state of residence.

C. For the purposes of this regulation, the term "investment entity" means a pass-through entity, as that term is defined in Section 7-3-2 NMSA 1978, meeting the following criteria:

- (1) the entity is not a dealer holding securities for sale to customers in the ordinary course of the entity's trade or business;
- (2) each of the entity's owners during the taxable year is an individual; and
- (3) ninety percent or more of the entity's income during the taxable year derives from the purchase or sales of securities or from writing of securities option contracts.

New York

N.Y. Comp. Codes R. & Regs. tit. 20, § 1-3.2(a)(6)

(i) A foreign corporation is doing business, employing capital, owning or leasing property or maintaining an office in New York State if it is a limited partner of a partnership, other than a portfolio investment partnership, which is doing business, employing capital, owning or leasing property or maintaining an office in New York State and if it is engaged, directly or indirectly, in the participation in or the domination or control of all or any portion of the business activities or affairs of the partnership. A foreign corporation is engaged in such manner in the business activities or affairs of the partnership if one or more of certain factual situations, including but not limited to the following, exist during the taxable year or, except for clause (a) of this subparagraph, any previous taxable year:

(iii) As used in this paragraph, the following terms have these meanings:

(d) The term portfolio investment partnership means a limited partnership which meets the gross income requirement of section 851(b)(2) of the Internal Revenue Code. For purposes of the preceding sentence, income and gains from commodities (not described in section 1221[1] of such Code) or from futures, forwards, and options with respect to such commodities shall be included in income which qualifies to meet such gross income requirement. Such commodities must be of a kind customarily dealt in on an organized commodity exchange and the transaction must be of a kind customarily consummated at such place, as required by section 864(b)(2)(B)(iii) of such Code. To the extent that such a partnership has income and gains from commodities (not described in section 1221[1] of such code) or from futures, forwards, and options with respect to such commodities, such income and gains must be derived by a partnership which is not a dealer in commodities and is trading for its own account as described in section 864(b)(2)(B)(ii) of the Internal Revenue Code. The term portfolio investment partnership shall not include a dealer (with- in the meaning of section 1236 of the Internal Revenue Code) in stocks or securities.

North Carolina

N.C. Admin. Code tit. 17, r. 06B.3503(c) Investment Partnerships -- A partnership whose only activity is as an investment partnership shall not be considered to be doing business in North Carolina. An investment partnership means a partnership that is not a "dealer in securities," as defined in section 475(c)(1) of the Internal Revenue Code, and that derives income exclusively from buying, holding, and selling securities for its own account. If any of the partnership's income is from other activities, either within or outside this State, either received directly or flowing through from other pass-through entities, the partnership is not an investment partnership for North Carolina tax purposes. Other activities include providing services or products to customers and holding real property for appreciation and income. An investment partnership shall not be required to file an income tax return in North Carolina or pay income tax to North Carolina on behalf of its nonresident partners.

Ohio

Ohio Rev. Code Ann. § 5733.401

(A) As used in this section:

(1) "Investment pass-through entity" means a pass-through entity having for its qualifying taxable year at least ninety per cent of its gross income from transaction fees in connection with the acquisition, ownership, or disposition of intangible property, loan fees, financing fees, consent fees, waiver fees, application fees, net management fees, dividend income, interest income, net capital gains from the sale or exchange of intangible property, or distributive shares of income from pass-through entities; and having for its qualifying taxable year at least ninety per cent of the net book value of its assets represented by intangible assets. Such percentages shall be the quarterly average of those percentages as calculated during the pass-through entity's taxable year.

(2) "Net management fees" means management fees that a pass-through entity earns or receives from all sources, reduced by management fees that the pass-through entity incurs or pays to any person.

(B) For the purposes of divisions (A) and (C) of this section only, an investment in a pass-through entity shall be deemed to be an investment in an intangible asset, and sections 5733.057 and 5747.231 of the Revised Code do not apply for the purposes of making the determinations required by division (A) of this section or claiming the exclusion provided by division (C) of this section.

(C)

(1) Except as otherwise provided in division (C)(2) of this section, for the purposes of division (A) of section 5733.40 of the Revised Code, an investment pass-through entity shall exclude from the calculation of the adjusted qualifying amount the portion of the investment pass-through entity's net income attributable to transaction fees in connection with the acquisition, ownership, or disposition of intangible property; loan fees; financing fees; consent fees; waiver fees; application fees; net management fees; dividend income; interest income; net capital gains from the sale, exchange, or other disposition of intangible property; and all types and classifications of income attributable to distributive shares of income from other pass-through entities. Nothing in this division shall be construed to provide for an exclusion of any item from adjusted qualifying amount more than once.

(2) Notwithstanding division (C)(1) of this section, the portion of the investment pass-through entity's net income attributable to net management fees shall not be excluded from the calculation of the adjusted qualifying amount if such net management fees exceed five per cent of the entity's net income calculated in accordance with generally accepted accounting principles.

Ohio Rev. Code Ann. § 5733.402

(A) Notwithstanding section 5733.40, 5733.41, 5747.41, or 5747.43 of the Revised Code, but subject to divisions (B), (C), and (D) of this section, for taxable years beginning after 1997, a qualifying pass-through entity, hereinafter the "exempt entity," is not subject to the taxes imposed by and required to be paid under those sections with respect to distributive shares of income and gain that pass through from the qualifying pass-through entity to another qualifying pass-through entity, hereinafter the "investing entity," if the investing entity irrevocably acknowledges that it has nexus with this state under the Constitution of the United States during the exempt entity's entire taxable year.

(B)

(1) Division (A) of this section does not apply to the extent that the investing entity fails to make a good faith and reasonable effort to comply on a reasonably timely basis with section 5733.41 and sections 5747.41 to 5747.453 of the Revised Code.

(2) The investing entity and the exempt entity bears the burden of establishing by a preponderance of the evidence that the investing entity made a good faith and reasonable effort to comply on a reasonably timely basis with section 5733.41 and sections 5747.41 to 5747.453 of the Revised Code.

(3) This section does not modify, reduce, abate, defer, postpone, or bar the imposition of and the required payment of any fee, interest, or penalty otherwise due under Title LVII [57] of the Revised Code.

(C) Except as otherwise provided in division (D) of this section, nothing in this section shall be construed to deny the application of division (A) of this section to the distributive share of income and gain of an investing entity that, with respect to that distributive share, is itself an exempt entity with respect to another qualifying pass-through entity, hereinafter the "upper level investing entity," if the upper level investing entity irrevocably acknowledges that it has nexus with this state under the Constitution of the United States during the investing entity's entire taxable year. Division (B) of this section also applies to the upper level investing entity. This division applies regardless of the number of levels of investing entities.

(D) An investing entity or upper level investing entity does not include an investment pass-through entity as defined in section 5733.401 of the Revised Code, and division (A) of this section does not apply with respect to any distributive shares of income or gain that pass through to an investment pass-through entity.

Oregon

Oregon Revenue Bulletin No. 2010-02

Partnership minimum tax

Investment partnerships: A partnership whose purpose is investing (often called an investment club) generally isn't doing business in Oregon if it simply pools resources to hold stocks and securities for long-term investment. Therefore, it generally isn't required to pay the partnership minimum tax. The club still must file a partnership return if it has Oregon-source income or one of the partners is an Oregon resident. Many investment clubs don't owe the partnership minimum tax. However, labels are not determinative, and one must consider the partnership's facts and circumstances. An investment club may be doing business in Oregon—and subject to the partnership minimum tax—if it regularly conducts short-term trading for profit, or conducts substantial and continuous activities marketing portfolio investments.

Texas

Tex. Tax Code § 171.0002. Definition Of Taxable Entity

(a) Except as otherwise provided by this section, "taxable entity" means a partnership, limited liability partnership, corporation, banking corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture, joint stock company, holding company, or other legal entity. The term includes a combined group. A joint venture does not include joint operating or co-ownership arrangements meeting the requirements of Treasury Regulation Section 1.761-2(a)(3) that elect out of federal partnership treatment as provided by Section 761(a), Internal Revenue Code.

(b) "Taxable entity" does not include:

(1) a sole proprietorship;

(2) a general partnership:

(A) the direct ownership of which is entirely composed of natural persons; and

(B) the liability of which is not limited under a statute of this state or another state, including by registration as a limited liability partnership;

(3) a passive entity as defined by Section 171.0003; or

(4) an entity that is exempt from taxation under Subchapter B.

Tex. Tax Code § 171.0003

(a) An entity is a passive entity only if:

(1) the entity is a general or limited partnership or a trust, other than a business trust;

(2) during the period on which margin is based, the entity's federal gross income consists of at least 90 percent of the following income:

(A) dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from a limited liability company;

(B) distributive shares of partnership income to the extent that those distributive shares of income are greater than zero;

(C) capital gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange, and gains from the sale of securities; and

(D) royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests; and

(3) the entity does not receive more than 10 percent of its federal gross income from conducting an active trade or business.

(a-1) In making the computation under Subsection (a)(3), income described by Subsection (a)(2) may not be treated as income from conducting an active trade or business.

(b) The income described by Subsection (a)(2) does not include:

(1) rent; or

(2) income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement.

34 Tex. Admin. Code § 3.582

(c) Qualification as a passive entity. To qualify as a passive entity:

(1) the entity must be one of the following for the entire period on which the tax is based:

(A) general partnership;

(B) limited partnership;

(C) limited liability partnership; or

(D) trust, other than a business trust; and

(2) at least 90% of an entity's federal gross income for the period on which margin is based must consist of the following sources of income:

(A) dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlements or termination payments with respect to a financial instrument, and income from a limited liability company;

(B) distributive shares of partnership income to the extent that those distributive shares of income are greater than zero;

(C) net capital gains from the sale of real property, net gains from the sale of commodities traded on a commodities exchange, and net gains from the sale of securities; and

(D) royalties from mineral properties, bonuses from mineral properties, delay rental income from mineral properties and income from other nonoperating mineral interests including nonoperating working interests not described in subsection (d)(2) of this section.

(3) An entity with no federal gross income does not qualify as a passive entity under paragraph (2) of this subsection.

(d) The income described by subsection (c)(2) of this section, does not include:

(1) rent; or

(2) income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement.

(e) Conducting an active trade or business. To be considered a passive entity, an entity may not receive more than 10% of its federal gross income for the period on which margin is based from conducting an active trade or business. Income described by subsection (c)(2) of this section, may not be treated as income from conducting an active trade or business.

Utah

Utah Code Ann. R865-9I-13. Pass-Through Entity Withholding Pursuant to Utah Code Ann. Sections 59-10-116, 59-10-117, 59-10-118, 59-10-1403.2, and 59-10-1405

(1) A pass-through entity must withhold and pay over to the state a tax on:

(a) the business income of the pass-through entity to the extent the business income is derived from Utah sources in accordance with Section 59-10-116; and

(b) the nonbusiness income of the pass-through entity derived from or connected with Utah sources.

(i) "Nonbusiness income of the pass-through entity derived from or connected with Utah sources" does not include portfolio income if the income would not be reportable to Utah on the pass-through entity taxpayer's Utah state tax return or the Utah state tax return of any downstream pass-through entity taxpayer.

(ii) "Downstream pass-through entity taxpayer" means a pass-through entity taxpayer that is a pass-through entity taxpayer of any entity that is itself a pass-through entity taxpayer.

Virginia

Virginia Tax Bulletin VTB 05-6

Investment Pass-Through Entities

Previous rulings have held that pass-through entities that are established solely to invest in intangible personal property, such as stocks and bonds, and that have no employees, and no real or tangible property (hereafter referred to as "investment pass-through entities") are not considered to be carrying on a trade or business. See Public Documents (P.D.) 94-275 (9/16/94), 95-280 (11/3/95), and 96-42 (4/10/96). Thus, the income from the intangible property held by an investment pass-through entity is not income from Virginia sources, and these types of pass-through entities will not be required to file the new Form 502.

The person who manages the investments of such a pass-through entity will be subject to taxation in Virginia if the manager carries on any business in Virginia and will be required to file the appropriate return. The fact that the manager of an investment pass-through entity is located in Virginia will not cause the income of the investment pass-through entity to be considered income from Virginia sources, whether the manager is one of the owners of the investment pass-through entity or an unrelated party.

The income, deductions and other attributes of an investment pass-through entity will pass through to its owners and be included in the federal adjusted gross income or federal taxable income of each individual or corporate owner. The impact of such income on the Virginia tax liability of the owner is as follows:

Residents: Individuals who are residents of Virginia will file a Form 760 reporting their federal adjusted gross income. Any income from an investment pass-through entity that is included in federal adjusted gross income will not be considered income derived from another state based solely on the fact that the state in which the investment PTE is organized or managed is other than Virginia.

Nonresidents: Individuals who are not residents of Virginia will not be required to file a nonresident Virginia income tax return solely because of income from an investment pass-through entity. If they have other income from Virginia sources requiring the filing of a nonresident income tax return, the income derived from an investment pass-through entity will not be considered income from Virginia sources even if the [sic] an investment pass-through entity is organized under Virginia law or managed by a person located in Virginia.

Corporations:

Nexus: Corporations will not be required to file a Virginia income tax return solely because of income from an investment pass-through entity. If a corporation has other income from Virginia sources requiring the filing of a Virginia income tax return, the income derived from such a pass-through entity will not be considered gross receipts attributable to Virginia for purposes of the sales factor solely because an unrelated party located in Virginia is managing the intangible assets of the investment pass-through entity or otherwise conducting income-producing activity on behalf of the investment pass-through entity.

Apportionment Factors: In general, corporations that are limited partners do not include their shares of partnership property, payroll and sales in the numerator or denominator for purposes of determining their Virginia apportionment factors. Under P.D. 95-19 (2/13/95), however, when the limited partner and the general partner are related parties and the affiliated group holds a substantial amount of the partner-

ship interests, the limited partner may be required to include its proportionate share of the limited partnership's property, payroll and sales for purposes of determining its Virginia apportionment factor.

Apportionable Income: Under Virginia law, all income of a multistate corporation, other than dividends, is generally apportionable. Corporations may request an alternative method of allocation and apportionment in which certain investment function income is allocable to specific states. This requires a facts and circumstances analysis and general rules cannot be provided. The relationship between the corporate owner and the manager of the investment pass-through entity would be one of many relevant factors in the determination as to whether an alternative method will be allowed as well as whether an adjustment to taxable income is required under Va. Code §§ 58.1-445 or 58.1-446.

Royalty addback: If the intangible assets of the investment pass-through entity consist of patents, copyrights, trademarks and similar assets, any royalties or other payments by a corporate owner or its affiliated entities to the investment pass-through entity with respect to such assets may be subject to the add-back requirements of Va. Code § 58.1-402 C (8).

SECTION IV: ANALYSIS SOURCING OF INVESTMENT PARTNERSHIP INCOME

[RENDING]